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VALUING PERSONAL CONSUMPTION: Cost Versus Value and the Impact of Insurance

Daniel Halperin[*]

"An ideal income tax would perhaps differentiate among individuals according to their talents for using funds in consumption; but ... income taxes must [be based upon] measurable quantities! ... [c]onsumption, as an element of income, must be measured ... by outlays for consumption purposes."[1]

I. INTRODUCTION

Andy is excited. He has finally been able to get the money together for an expensive new car. After years of making do with a used car or cheaper models he is about to pick up a new $50,000 Mercedes sedan. But alas! Andy's dream of years of driving comfort are soon shattered. The car is a lemon. It is constantly in the shop for repairs wasting Andy's time and eventually costing him several thousand dollars. In the end, it never drives as well as expected.

Would an *ideal* tax system, as Simons suggests, take some account of Andy's misfortune? Should we, *if we could*, somehow determine what the car is really worth and allow Andy a deduction for the difference between that amount and his outlay of $50,000? Alternatively, should we *ideally* allow a deduction for the *extraordinary* cost of repairs, the amount spent

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* Professor of Law, Georgetown University Law Center. J.D. Harvard, 1961. Like many law professors, I have been thinking about the issues raised in this article for a long time. I am grateful to Boston University Law School for inviting me to a workshop which led to the initial draft of this article. I have benefitted from comments at that workshop, a workshop at Georgetown, and from comments received at a 1989 Seminar on Current Research in Taxation sponsored by the Harvard Law School Fund for Tax Research. I also want to thank my colleague Stephen Cohen as well as Professor Lawrence Lokken with whom I exchanged early drafts of our respective musings on this subject. Professor Lokken's draft stimulated my thinking on a number of points. I am particularly indebted to my colleague Richard Diamond for his suggestion which led to one of the central ideas in this article. My research assistants, particularly Daniel Luchsinger and Ajay Mehrotra, contributed enormously to this effort.

1. Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy, 119-20 (1938).

beyond what would *normally* be expected? Is our failure to take account of Andy's misfortune a concession to administerability rather than a matter of principle? This article explores the answer to that question as well as whether recoveries, from insurance or otherwise, should be taxable, if such losses are disallowed.

There are a number of reasons why there might be a great deal of difference between the amount of enjoyment derived from a consumer purchase and the cost to the individual on the market. Consumer surplus, circumstance of use, variation in quality, events subsequent to purchase, and changes in market price may explain the discrepancy between actual enjoyment and cost.

Consumer surplus is the difference between the amount the buyer is willing to pay and the market price.[2] The difference occurs because sellers cannot efficiently determine each buyer's willingness to pay, and hence cannot extract that amount in price. Thus, it is not possible for a seller, say of wine, to charge each consumer the amount she is willing to pay. For some, an excellent bottle of wine might be worth $50, but if there are not enough such individuals to buy the entire supply, the price will be lower. To simplify, the market price will be the highest price that will move the merchandise on hand. If a person would be willing to pay $50, but she can buy the bottle of wine for its market price of $30, she will be said to have obtained $20 of consumer surplus.[3]

Individuals will also differ in the circumstances under which they will use the product. A bottle of wine enjoyed with a loved one, perhaps on an anniversary or birthday or in the company of superior food, may take on additional value. Some purchases will be rarely used, such as an exercise bike purchased at a time when dreams of self-improvement momentarily took control.

Items which are supposedly alike may differ in actual quality. Some automobiles are lemons. There can be differences in taste among wines of the same vintage. If information is available as to the range of quality but not as to the quality of any particular item, one should expect the price to reflect average quality.[4] In other circumstances, perhaps due to fraud, all items of

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2. Paul A. Samuelson & William D. Nordhaus, Economics 733 (14th ed. 1992).

3. Inclusion of consumer surplus or other non-monetary satisfactions (watching sunsets) in the tax base, even if feasible, could lead to difficulty in payment of the tax for those for whom such satisfactions represent a large proportion of their income. Somehow the impact of the potential tax would have to be taken into account in determining the true amount of the benefit. See Daniel I. Halperin, Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem, 122 U. Pa. L. Rev. 859, 882-85 (1974). This matter is not pursued in this article.

4. While the price will reflect average quality in the case of new products, that may not be the case for used goods. The literature suggests that because everyone believes used

a particular product will turn out to be worth far less than the price charged.

This variation in quality may be reflected by differences in the cost of upkeep or repairs. If the value of consumption is based simply on expenditures, an automobile with a terrible repair record would be found, contrary to common understanding, to produce more enjoyment than one which is trouble free.[5]

A difference in value may also arise because of events, possibly fortuitous, which take place after the initial purchase. An automobile may be involved in an accident. A bottle of wine can break. A vacation may be ruined by bad weather, an elegant dinner because of the chef's disposition. Many arbitrary events can alter the identity between cost and amount of enjoyment.

Finally, there may be changes in relative market prices. A home or a work of art may increase or decline in value.[6] Arguably these gains and losses, whether from market fluctuation or otherwise, should be taken into account in an ideal tax system whether or not the asset is actually sold.

Currently, however, such gains and losses are generally ignored. Gains on consumption expenditures are recognized only upon sale or other disposition of the items. While certain medical expenses may be deducted,[7] other losses are taken into account only in the event of a "casualty"—a sudden unexpected and unusual event, such as a collision or fire, as opposed

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cars are "lemons" their price reflects the bottom of expected quality. See George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488, 489-90 (1970).

5. See Zarin v. Commissioner, 92 T.C. 1084, 1101 (1989) (Tannenwald, J., dissenting), rev'd, 916 F.2d 110 (3d Cir. 1990). In an analogous situation, Judge Tannenwald argued against the proposition "that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth." Id.

6. Sometimes a product may be sold for more than the purchase price even if the underlying market does not change. Thus, if a wine improves with age, its price can be expected to rise as it approaches the ideal time for consumption. For example, a bottle of wine purchased for $30 may be expected to sell 10 years later for $60 even if there is no change in the underlying market value for the wine. This increase in price reflects the fact that an individual who purchases the wine when it is first bottled gives up the opportunity to invest the sum devoted to the wine.

If he did not expect a return on this investment, he would wait and purchase the wine when it was ready for drinking. Although the difference between $30 and $60 does not reflect current use value, it seems related to imputed income on a consumer durable which is ordinarily not subject to tax.

Suppose, however, the price of the wine actually increases to $100. A sale of the wine for $100 would produce taxable income of $70, consisting of the imputed return of $30 and an increase in market price of $40.

7. IRC § 213(a).

to an unusually high cost of repair.[8] Further, while at one time casualty losses were deductible in full, such losses now can be deducted only to the extent that they are truly extraordinary in that losses for the year exceed 10% of adjusted gross income.[9] This article analyzes whether these results are correct as a matter of principle or merely—as Simons suggests—a concession to reality?[10]

A related question that this article also considers is whether insurance and tort recoveries that compensate for a loss related to a consumption item should be taxable. To illustrate, Andy may *not* be totally out-of-luck. The repairs are likely to be covered by a dealer warranty. In fact, under recently enacted legislation, in some states, he may be entitled to a new car to replace a "lemon."[11] If Andy's car were destroyed by collision or fire, he would probably recover the amount of his loss from either his insurance carrier or the tortfeasor who caused the damage.

Intuitively, I believe most of us would conclude that such recoveries or benefits from the dealer, a tortfeasor or an insurance carrier should not be taxable to Andy. After all he is no better off than those who did not suffer

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8. Personal losses are deductible only if they "arise from fire, storm, shipwreck, or other casualty, or from theft." IRC § 165(c)(3). The Internal Revenue Service has defined the terms "sudden," "unexpected," and "unusual" in the following manner:

> To be "sudden" the event must be one that is swift and precipitous and not gradual or progressive.
>
> To be "unexpected" the event must be one that is ordinarily unanticipated that occurs without the intent of the one who suffers the loss.
>
> To be "unusual" the event must be one that is extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damages occurred, and one that does not commonly occur in the ordinary course of day-to-day living of the taxpayer.

Rev. Rul. 72-592, 1972-2 C.B. 101, 101-02.

9. IRC § 165(h)(2).

10. "To abandon amounts paid and market prices as measures is to leave one's self stranded in the intellectual desert of subjective values and psychic *numeraires*." Simons, supra note 1, at 119.

> if one purchases a vacuum cleaner and finds that it will not sweep, this fact must be recognized in the computation of "final income." Such a proposition may seem too obvious to question; yet one may apply the same line of argument to purchases of patent cures that cure nothing, informational literature that misinforms, and almost everything sold by false representations.

Simons, supra note 1, at 120 (citing Economics and Accountancy 166 (1929)).

11. See e.g., Cal. Civ. Code § 1793.2 (West Supp. 1992); Fla. Stat. ch. 681.10-.118 (1991); Pa. Stat. Ann. tit. 73, §§ 1951-1963 (Supp. 1992); P.R. Laws Ann. tit. 10, §§ 2051-2065 (Supp. 1989); Va. Code Ann. §§ 59.1-207.9 to .16 (Michie 1992).

a loss. There is statutory support for this result.[12]

But insurance recoveries are not always nontaxable, as Hal Millsap discovered to his chagrin.[13] Millsap was not a lucky fellow. His residence was severely damaged by fire and became temporarily unusable. Fortunately for Millsap, his insurance policy provided him with $2,500 for temporary living expenses, sufficient, he thought, to bear the expense of a motel. But this turned out not to be true, as the Internal Revenue Service succeeded in including the proceeds in Millsap's income.[14]

My intuition that most of us would think this unfair turned out to be correct, as Congress quickly reacted to overturn this result.[15] In the future, people whose homes are damaged or destroyed by fire, storm or other casualty will not be subjected to tax on the portion of their insurance recovery for living expenses that exceeds their normal living expenses.[16] The legislation, however, is limited to the Millsap situation—extraordinary living expenses resulting from loss of use of occupancy of a principal residence—and does not cover such cases as car rental to replace a stolen car or even compensation for loss of use of a second residence.

Can any principle, beyond intuition, explain when and why a recovery from an insurance company or tortfeasor should be nontaxable? Can such a principle reconcile non-taxation of such recoveries with the lack of deduction to Andy if he is uninsured and personally bears the loss? Alternatively, would consistency require that a deduction be allowed to the unreimbursed Andys of the world to reflect the difference between their situation and the situation of those who were made whole without being subject to tax? In other words, should the tax system explicitly take account of any differences between expenditures and actual enjoyment of goods and services?

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12. A specific exemption applies to amounts received on account of death, IRC § 101, personal injury or sickness, IRC § 104(a)(3), for living expenses resulting from loss of use or occupancy of a principal residence due to a casualty such as fire or flood, IRC § 123, and for an insurance recovery, with respect to property destroyed by casualty, which is reinvested in similar property, IRC § 1033. The list of exceptions suggests insurance recoveries could be taxable in the absence of a specific statutory exemption. Most people probably believe there should be no taxable income to a tortfeasor when the insurance company pays a victim's claim against her but it is not clear how to reach this result under the present Code. Boris I. Bittker, A Comprehensive Income Tax Base? A Last Word 126 (1968); see Charles O. Galvin & Boris I. Bittker, The Income Tax: How Progressive Should it Be? 64 (1974).

13. Millsap v. Commissioner, 387 F.2d 420, 423 (8th Cir. 1968).

14. Id.

15. IRC § 123, titled "Amounts Received Under Insurance Contracts For Certain Living Expenses."

16. The exclusion is limited to the actual living expenses incurred during the period, in excess of the normal living expenses that would have been incurred during the period. IRC § 123(b).

Initially, it would seem that the answer to these questions requires an understanding of the proper tax base under an income tax system. An examination of the literature, as more fully described in Part II, does not, however, indicate any unanimity of opinion as to the proper role of the actual value of goods and services enjoyed by a taxpayer in determining the applicable tax base. Some suggest that consumption is irrelevant—we should care only about income, namely the amount available for consumption.[17] Others argue that ideally we should look to actual enjoyment of goods and services—taking into account differences that are both large and measurable.[18]

Since I believe that most significant losses are a result of voluntary behavior or could be avoided through insurance, I tend to prefer the *ex ante* approach. Further, if the *ex post* perspective were adopted, both equity and efficiency, in terms of incentive to insure, would require the recognition of gains (more than expected enjoyment) in addition to losses. Since I believe this is unlikely to occur, I ultimately conclude that regardless of whether in principle one favors an *ex ante* or *ex post* approach to measurement, consumption should normally be measured *ex ante* by the amount expended. As suggested, I reach this result because it can be shown that for administrative reasons an *ex ante* approach may in many instances be a better second best approximation of actual enjoyment than an attempt to measure such enjoyment is likely to be. Finally, I believe that exemption for insurance and other recoveries can generally be reconciled with nondeductibility of losses for those who are not reimbursed.

Because the degree of comfort one has with these suggestions may well depend upon one's view of the ideal tax base, I begin in Part II with a discussion of the "correct" tax base under an income tax. Although I deal with the issue on the assumption that we continue the present income tax base, the question must also be faced under a consumption tax which would generally be measured as income plus or minus the change in savings during

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17. Simons, supra note 1, at 139; see Mark G. Kelman, Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World, 31 Stan. L. Rev. 831, 835 (1979).

18. William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309, 313 (1972). According to Robert M. Haig:

> Modern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences.... If one spends his dollar [of income] for something more durable than a dinner—say a book or a pipe—is his true income the book or the pipe, or the series of satisfactions or "usances" arising from reading the book or smoking the pipe? There is no doubt as to the answer.... A man strives for the satisfaction of his wants and desires and not for objects for their own sake.

Robert M. Haig, The Concept of Income—Economic and Legal Aspects, in Readings in the Economics of Taxation 54, 55 (R. Musgrave & C. Shoup eds. 1959).

the year.[19] I then turn in Part III to the implementation of the *ex ante* and *ex post* alternatives without regard to the possibility of recoveries of loss from insurance, tortfeasors or otherwise. In Part IV, I explore the treatment of such recoveries. Part V, which concludes with a brief discussion of insurance to protect against loss of income, explores whether insurance raises total utility by providing security and peace of mind.

II. CHOOSING THE "PROPER" TAX BASE

I begin by considering whether the reason income is chosen as a tax base can help determine how income should be defined. Some view income as the best indicator of ability to pay for the cost of government.[20] They sometimes assert that the tax rates should be set to extract an equal level of personal sacrifice.[21] By itself "equality of sacrifice" is an ambiguous term. It can either mean that the loss of units of utility demanded of each individual be equal ("equal sacrifice") or that each taxpayer should be required to give up an equal percentage of total utility derived from income ("proportionate sacrifice").[22] If utility per dollar of expenditure declines as income rises, the latter interpretation would require progressive rates.

Others have more explicitly focused on the role of the income tax in redistributing society's resources. According to Professor Alvin C. Warren, "an income tax serves to deflect to the government, for the purpose of providing for public goods and for distribution of the remainder, a progressive portion of each citizen's share of the product otherwise allocated to him by transfers and the marketplace."[23] Professor Thomas Griffith, expressing a similar view, explicitly grounds his proposals upon principles of distributive justice.[24] He offers two notions of welfare maximization for consideration:

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19. See William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1149 (1974). Under the Andrews proposal, the tax base would be more or less as it is now decreased by any addition to savings or increased by withdrawal from savings.

20. See generally, Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 Cal. L. Rev. 1905 (1987).

21. For those who view the payment of taxes as a "coerced contribution to the government ... a confiscation of property," the equality of sacrifice argument assures that the pain associated with taxes is apportioned equitably. Walter J. Blum & Harry Kalven, Jr., The Uneasy Case for Progressive Taxation, 19 U. Chi. L. Rev. 417, 455 (1952). Generally, this argument ignores the government benefits originating from taxation and concentrates on the sacrifices taxes entail.

22. Id. at 457.

23. Alvin Warren, Would A Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081, 1090 (1980).

24. Thomas D. Griffith, Theories of Personal Deductions in the Income Tax, 40 Hastings L.J. 343, 345 (1989). Griffith criticizes Professors Kelman and Andrews for not

maximizing total societal welfare, utilitarianism, or improving the lot of the least well-off member of society, the Rawlsian maximin.[25]

Griffith's model assumes that the marginal utility from any given expenditure declines as income rises and is the same for all individuals at any income level.[26] If the tax is to be assessed so as to cause the minimum reduction of total individual utility, it follows that, except for incentive effects, the tax rate would be 100% at the highest income levels until the requisite revenue was collected.[27] In measuring the base, any expenditures that do not provide utility, which in this model would include medical expenses, should be excluded.[28]

In any event, whether the goal is redistribution, or equal division of sacrifice, for the goal to be accomplished the tax base must correctly measure resources. Redistribution requires that we take more from those who enjoy greater resources in order to provide for those who initially have smaller claims. Equality of proportional sacrifice also requires that those with more resources should pay more tax. In either case, two individuals with the same resources should pay the same tax.

It is not clear, however, what we mean by resources in this regard. As Henry Simons described it, *income* is the algebraic sum of *consumption*[29] and *accumulation*.[30] One way of thinking about Simons's maxim is to focus on the term income, the right side of the equation being merely descriptive of the only two uses of income. If one takes this view, one might well conclude that how one spends income and the results of such spending are irrelevant.[31] Income is important not use.

Professor William D. Andrews, on the other hand, focused on the right side of Simons's formulation[32] and concluded that the ideal tax base

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explicitly grounding their proposals upon any "coherent normative principle," such as a principle of distributive justice. Id.

25. Id. Utilitarianism seeks to provide the greatest good to the greatest number; thus, it is willing to sacrifice individual desires in the name of maximizing society's total benefit. The Rawlsian maxim, with its bottomup perspective, proposes to maximize the utility of the marginal members of society, despite the decrease in society's total benefits.

26. Id. at 392-93.

27. Id. at 394.

28. Id.

29. More precisely, Simons defines consumption as "the market value of rights exercised in consumption," which, if taken literally, means that Simons would not have taken account of what was actually consumed. Simons, supra note 1, at 50.

30. Simons defines accumulation as "the change in the value of the store of property rights between the beginning and the end of the period in question." Simons, supra note 1, at 50.

31. See Kelman, supra note 17, at 835.

32. See Andrews, supra note 18, at 313. Of course, such an interpretation of Simons's maxim makes a "shift toward a more explicitly consumption-oriented tax ... appear

took account of the actual value of goods and services or consumption enjoyed by the taxpayer.[33] According to Professor Andrews, consumption outcomes ought to be taken into account when it is reasonable to do so, such as when there are large differences that are administratively feasible to measure.[34]

Professor Andrews's provocative article has led, in recent years, to a lively debate about the proper role of personal deductions under an income tax.[35] The arguments raised in this debate, particularly with respect to medical expenses[36] and casualty losses,[37] are relevant to the more general question considered herein: Should the value of consumption expenditures ideally be based on the market price or on the amount of actual enjoyment to the taxpayer? We now turn to this debate concerning the proper tax base. Possible bases include earning capacity, power to consume after taking account of the extent to which earning capacity has been exercised, and ultimate utility or satisfaction perhaps only taking account of involuntary losses of utility.

A. *Alternative Standards*

1. *Earning Capacity.*—It might be said that ideally an income tax should be based upon earning capacity. This method would best reflect the individual's potential to acquire resources and thus may "best assess the sacrifice a particular taxpayer is making when he is asked to give a certain sum of money to the state."[38]

Implementation of this concept raises a number of questions. Would

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much less radical than it is commonly assumed to be." Andrews, supra note 18, at 317.

Recognition of the importance of the consumption element lends support to my view that entertainment and other forms of enjoyment derived while engaged in business should ideally be included in the tax base even if the expenditure is wholly justified for business reasons. See Halperin, supra note 3, at 862.

33. Andrews, supra note 18, at 313.

34. Andrews, supra note 18, at 329-330.

35. A variety of personal expenditures are deductible under the present income tax, including medical expenses, IRC § 213 and casualty losses, IRC § 165(c)(3).

36. See Griffith, supra note 24; Louis Kaplow, The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums, 79 Cal. L. Rev. 1485, 1493-99 (1991); Kelman, supra note 17, at 858-79.

37. See Kaplow, supra note 36, at 1489-93 for a discussion concerning casualty losses.

38. Kelman, supra note 17, at 841. Although Professor Kelman raises the earning capacity argument, he ultimately rejects this standard in favor of a net receipts tax. He believes "that once people deliberately exercise their earning power in the market, the tax system should measure their relative positions as a prelude to redistribution." Kelman, supra note 17, at 880.

actual earnings in excess of the amount expected from an individual of a particular ability also be taken into account? While individuals who spend their time beachcombing or who leave their money in a mattress would have some income imputed to them, it is more difficult to determine the correct treatment of a taxpayer who tries but is unsuccessful, either in investment or in exploiting the value of her personal services. The assertion that you should have done better and, therefore, we will include more than you actually earned in income is troubling, I think, even under a capacity approach.

These questions have not been explored because no one argues that the tax base should actually be based upon capacity. There are two reasons. First, such a tax would violate the simple libertarian principle that the state should not require people to engage in particular activities. For example, if the tax were based on how much a taxpayer could earn, a law school professor might be forced to practice law in order to pay the tax. Second, measurement of earning capacity would be too intrusive. Presumably, in addition to education level, one would have to measure such attributes as intelligence, judgment and charm.[39]

2. *Income or Power to Consume.*—These concerns could lead one to reject earning capacity as a tax base in favor of income or realized power to consume. This approach is responsive to the belief, based on administrative grounds, that the tax base must be measured mostly by money earned in market transactions. It also would be simpler to implement and far less intrusive than efforts to measure either earning capacity or the actual value of consumption.

Beyond administerability, there is logic to measuring taxable capacity by power to consume. The assertion that equality of such power is all we can hope to achieve is appealing. As Kelman puts it, "[o]nce the taxpayer voluntarily takes control of resources, her particular subsequent uses of those resources are irrelevant to tax law."[40] Behavior will be most efficient if individuals bear the full burden of their errors. At least in terms of expectancy, the individual will get what he pays for and even outcomes will often be subject to the individual's control. For example, one who does not research thoroughly before purchasing can expect to get less bang for the buck. In addition, variations in outcome could in some circumstances be prevented by adopting less risky behavior or by the purchase of insurance. Although I think the issue is a close one, on balance, I find the arguments for the income approach more persuasive than those in favor of the actual enjoyment approach.

3. *Actual Enjoyment.*—There is, nevertheless, force to the idea that the disparities we are concerned with are disparities in actual enjoyment of

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39. See generally Kelman, supra note 17, at 855.

40. Kelman, supra note 17, at 835.

real goods and services.[41] This may be particularly true if failure to utilize consumption power to the fullest is not the fault of the individual. In many cases, consumers constrained by limited resources cannot adequately prevent losses.[42]

According to Professor Andrews, while the concept of ability to pay may suggest that taxes should be levied by the receipt of income (which shows such ability, whether or not it is devoted to personal consumption), an ideal personal income tax would apportion tax burdens to a taxpayer's "aggregate personal consumption plus accumulation of real goods and services."[43] "[I]ncome once earned and received is [not] income whatever is done with it."[44] Andrews's focus on ultimate enjoyment of real goods and services makes sense "if we think part of the purpose of a graduated income tax is relative redistribution ... [since] [w]hat we mean to redistribute ... must be shares of real goods and services which persons otherwise would be consuming...."[45]

According to Andrews, "[w]e rely on money expenditures to provide a practical measure of the real consumption ... which such spending buys" only because we cannot measure consumption directly.[46] But, "if consumption ... of real goods and services is less than ... money income ... in any substantial and ascertainable way, ... that discrepancy should be adjusted for by a deduction from money income."[47]

Griffith's focus on minimizing sacrifice would also apparently lead to a tax base based on actual enjoyment. Griffith appears to agree with Andrews that an "unvarnished net income tax base would not ... redistribute to those most in need ... because net income is likely to be a less accurate measure of need than a tax base that takes into account such items as medical expenses and casualty losses...."[48]

Professor Stanley A. Koppelman also advocates a more direct linkage

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41. Andrews, supra note 18, at 326.

42. The poor are more often victimized by limited outlets, insufficient consumer information and exploitative rental policies. Cf. Kelman, supra note 17, at 860 n.87 (noting that the poor are more likely to make "bad buys").

43. Andrews, supra note 18, at 327. Andrews says the tax should be based on consumption of real goods and services because that is what will be ultimately sacrificed to pay the tax. Andrews, supra note 18, at 327. Many have noted, however, that there would not necessarily have to be an identity between the tax base and the medium of payment. See e.g., Halperin, supra note 3, at 883.

44. Andrews, supra note 18, at 325.

45. Andrews, supra note 18, at 326.

46. Andrews, supra note 18, at 327.

47. Andrews, supra note 18, at 325.

48. Griffith, supra note 24, at 384.

between the tax base and theories of welfare maximization,[49] such as Rawlsian or utilitarian philosophy.[50] Under his view, "the consumption component of income involves the exercise of economic consumption power in a manner intended to produce a current personal benefit."[51] While voluntary expenditures unrelated to profit-seeking activity should be considered taxable consumption, Koppelman agrees that deductions for involuntary expenditures may be justified because the involuntary nature of the transactions may suggest that the taxpayer does not receive personal value equal to the amount of the expenditure.[52] There may be no personal benefit because "the expenditure compensates for a psychic, noneconomic loss which necessitated the expenditure."[53]

B. *Choosing the Base*

This discussion suggests that a reasoned argument could be made either for the view that ultimate enjoyment should be taken into account or that we should focus solely on expenditures without regard to how things work out. In all likelihood neither reason nor logic will help us choose between an *ex ante* or *ex post* approach to measuring the benefit of consumption expenditures. This dilemma could be avoided, however, if we could conclude either that there is not likely to be a material difference in the results of the two approaches, or that, because of likely imperfections in implementing the *ex post* perspective, it is unlikely to do a better job of measuring actual consumption than the *ex ante* method. These questions are discussed in the next section.

III. IMPLEMENTATION OF *EX ANTE* OR *EX POST* APPROACH

In this Part, I explore a number of points which relate to the question of whether a tax system which ignores consumption gains and losses is, nevertheless, likely to give a fairer picture of ultimate satisfaction than one which uses an *ex post*, direct, measure of such enjoyment.

I believe that the *ex ante* approach may be more accurate for a number of reasons. First, there is no reason to suspect that there would often be large differences between expenditures and enjoyment. In part this is true because what at first glance appears to be a loss may on a closer examination

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49. See Stanley A. Koppelman, Personal Deductions Under an Ideal Income Tax, 43 Tax L. Rev. 679, 697-704 (1988).

50. Id. at 698-700.

51. Id. at 705.

52. Id. at 709.

53. Id. at 710.

be merely a reflection of a pattern of consumption. In addition, we might expect losses and gains to even out. But it seems likely, as is developed below, that any attempt to measure consumption *ex post* would not only exclude some losses while allowing others, but more importantly would systematically exclude gains while allowing losses. If this is the case an *ex post* approach would understate aggregate income and it may well tend to exclude gains achieved by the very persons whose losses would be taken into account. Finally measuring consumption *ex ante* does not preclude taking into account an increase in the market value of housing and other consumer durables.

A. Ex Ante *and* Ex Post *Measures May Not Differ Significantly*

If there is no reason to suspect that any one individual or class of individuals is likely to experience unusual differences between cost and actual enjoyment, it is at least possible that the purchase price will give a fair indication of overall enjoyment. To pursue this further, let us look at the reasons previously identified as causes for the difference between purchase price and outcome.

Consumer surplus, which measures the difference between willingness to pay and price, is one reason for the difference between cost and actual enjoyment. I see no reason why consumer surplus would not be somewhat equally distributed, at least among people in the same income class. Some suggest that consumer surplus is not "distributed unevenly across classes; thus, it poses no vertical equity problems."[54] On the other hand, it seems to me that those with large amounts of income would willingly pay much more than market price for such items as ordinary entertainment and travel.[55] This income effect would create larger consumer surplus for each dollar spent by the well-to-do.

Although changes in market prices and variation in the quality of the particular item among models should be random, choosing wisely among models and avoiding fraud and misrepresentation might not be. One suspects that the less well off or the less well educated are more likely to be victimized by lower quality products as they have less resources with which to research potential purchases and access to fewer sales outlets.[56]

Still, if the amount of difference between cost and outcome is not

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54. Mark G. Kelman, Time Preference and Tax Equity, 35 Stan. L. Rev. 649, 657 n.23 (1983).

55. But see Herbert Hovenkamp, Positivism in Law & Economics, 78 Cal. L. Rev. 815, 839-40 (1990) (arguing that while the rich may have a greater willingness to pay, that does not necessarily mean they achieve greater utility from a purchase).

56. See Kelman, supra note 17, at 860 n.87.

likely to be significant among people at a particular income level, it may not be important that there might be large differences between one income level and another. These vertical differences can be handled by varying the rates more than the amount required by the desired degree of progression.[57] Suppose a rate of 15% was imposed on lower levels of income and a rate of 28% on higher levels of income on the assumption that the tax base correctly reflected all resources or at least an equal proportion thereof. If it were believed likely that income at the higher level was understated to a greater degree, lowering the 15.0% rate to 14.5% and/or raising the 28.0% rate to 28.5% could ameliorate the vertical inequity. I recognize that it may be naive to believe that rates are chosen solely to achieve a certain distribution. There may be political or efficiency objections to higher rates even if the distribution of resources is less than "ideal." For example, high marginal rates may be said to inhibit investment or work effort. Nevertheless, at least in theory, vertical inequities can be eliminated through a rate adjustment without correcting the tax base.

B. *Apparent Losses Are Not Always Real*

While we all may commonly experience "the minor frustrations of life," the burdens of serious casualties and illnesses may not be equally distributed even at a particular income level. Andrews suggests there would be "large differences in ... [the] magnitude ... [of medical expenses] between people in otherwise similar circumstances."[58] This also seems to be the view of Professor Boris I. Bittker who defends the deduction for casualty losses as follows.

> In a statistical sense, of course, destruction by fire is one of the hazards of home ownership "voluntarily" assumed when the taxpayer chooses to buy a personal residence. But if a dog can distinguish between being kicked and being stumbled over, as Holmes asserted, we can properly distinguish between the minor frustrations of life—a cigarette burn in a rug, a dented fender, a quarter lost when fumbling for change to put in a parking meter—and major casualties ("sudden, unexpected, and unusual" events that do not "commonly occur in the ordinary course of day-to-day living").[59]

57. Griffith, supra note 24, at 360-363.

58. Andrews, supra note 18, at 336.

59. Boris I. Bittker, Income Tax Deductions, Credits and Subsidies for Personal Expenditures, 16 J.L. & Econ. 193, 197 (1973). Bittker draws some support for the casualty

On the other hand, it may be that what appears to be bad luck would often be a direct result of the consumer's behavior. For example, according to Kelman, it is plausible that "most medical needs really arise from voluntary decisions to pursue potentially unhealthful activity"[60] such as smoking, skiing, or not closeting oneself away from potentially tortious automobile drivers. Thus, Kelman asserts that many departures from good health result from past decisions that gave the taxpayer untaxed benefits.[61]

> A deduction for loss of health without inclusion of the gains from such risky activities will mismeasure how relatively well-off two taxpayers are.... Recognizing that medical spending may involve discretion before illness manifests itself, it is no longer plausible to say that such spending "restores" the taxpayer to a baseline position enjoyed by those without medical care "needs."[62]

Professor Koppelman finds, for different reasons, that most currently deducted medical expenditures have a strong voluntary component.[63] Since those claiming the medical deduction are typically insured against involuntary costs, he believes generally their uninsured expenditures are at least in some sense voluntary.[64] Thus, it cannot be said that medical treatment merely restored the pre-illness condition.

Clocking more miles, driving faster than average or improper care of an automobile are additional examples of voluntary activities that provide

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loss deduction from an example which purports to show that you need to reach a peculiar conclusion to justify determining Simons's income without regard to a casualty loss. In Bittker's example, a taxpayer who earns $50,000, spends $20,000 on necessities, and $30,000 to replace a $20,000 residence destroyed by fire. According to Bittker, since increase in net worth is $10,000 (new residence $30,000 compared to old residence $20,000), consumption must be $40,000 which can only come from $20,000 of necessities and $20,000 of old residence literally consumed by fire. Bittker, 16 J.L. & Econ. 193, at 196. However, it would seem more accurate to measure lifetime consumption from a residence by the purchase price in the year of acquisition. Andrews, supra note 19, at 1157-58. Under this view, the old residence does not enter into the calculation. There is $50,000 of consumption—$20,000 of necessities and $30,000 from the new residence.

60. Kelman, supra note 17, at 869.

61. Kelman, supra note 17, at 869. Of course, no one is suggesting this is true of all illness.

62. Kelman, supra note 17 at 869.

63. Koppelman, supra note 49, at 712-13.

64. Koppelman, supra note 49, at 712-13. Of course this is not true to the extent that a loss of job leads to loss of health insurance, and an individual is unable to secure a policy which will cover pre-existing conditions. It is not clear how many people in this position substantially benefit from the medical expense deduction. In any event the true solution to the problem is continuing insurance coverage, not tax relief.

unaccountable benefits. The car may depreciate more than expected, but the owner has also derived more consumption, or increased her leisure time.

Furthermore, differences in the quality of purchases which result among taxpayers, perhaps even at the same income level, could arise in part because some individuals spend more time on shopping and research, reading *Consumer Reports* and the like. In a sense the better outcome merely reflects the fact that the expected value among the more cautious group can be said to be higher than that for those who are more cavalier in their purchases. However, members of the cavalier group, all other things being equal, are able to enjoy more leisure time, which, unlike the cautious group, they presumably value more highly than time spent on research. For example, members of the cautious group, after expending five hours on research, each spend $1,000 on an item and the item averages $1,050 in overall quality. Members of the more cavalier group also each spend $1,000 on a similar product, but forgo the research and therefore purchase items that average $1,000 in quality. The cavalier consumers also have five more hours of leisure which they value at more than $50. Thus, the cautious consumers' research raised their expectancy for the product that invariably led to a greater outcome. The cavalier consumers knew, in the absence of research, they might not get the best product (for example, they had an expected value of only $1,000) but believed the extra leisure time was worth the difference. In both cases average *ex post* results did not differ from what was expected *ex ante*. In short, differences in outcome are merely a reflection of a lifestyle providing additional noneconomic pleasures.

Persons who choose not to insure when insurance is available will get a greater difference between expectancy and outcome than those who choose to insure. The same can be said for those who make more risky consumption choices. While in these cases there may be a real difference between expectancy and outcome, it seems to me that the concerns which lead one to prefer a tax base which takes account of actual enjoyment, as opposed to mere opportunity to consume, may not extend to those whose losses are in this sense voluntary.[65]

C. *Attempts to Measure Outcomes Will Be Incomplete*

In this section, I explore the possibility that even if actual losses can

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65. This latter point seems even stronger if what is lost is a luxury item rather than a necessity which must be replaced. See Koppelman, supra note 49, at 709. We will also see later that allowing the uninsured to deduct losses is likely to be unfair because they will tend to have gains which will be ignored. Thus, if uninsured losses could be deducted there would be a disincentive to insure which would lead to inefficient behavior. Kaplow, supra note 36, at 1491.

be identified, an *ex ante* approach might still come closer to measuring actual enjoyment than an attempt to measure outcomes. First, past experience would indicate we might only take account of selected losses. Perhaps more importantly, although it has not been generally understood, many of the transactions that can cause losses can also provide gains to others. Since these gains are unlikely to be recognized, taking account of losses could unfairly skew the base. This would be particularly troublesome if it is likely that the people who would tend to have losses are also more likely to have gains.

1. *Consumption Windfalls.*—It may be that sometimes people make expenditures that do not increase their consumption. Individuals incurring such costs may have a claim to a deduction. If so, however, there are others who enjoy a benefit because they spend less than they expected, to achieve a certain level of enjoyment.[66] These people should have additional income. To illustrate, I present first the purchase and operation of an automobile, and then turn to medical expenses and casualty losses, which have been the subject of extensive discussion.[67]

Assume Bob purchases a car for $10,000. To determine whether the purchase is worthwhile, Bob would take account of the costs of operation, including maintenance and insurance, as well as his initial outlay, and compare the total costs with the benefits of driving. Assume that Bob expects his costs to average $5,000 a year, but the car needs extensive repairs over its life, so the average annual cost is $6,000.[68] Annual costs will also be more than expected if the car depreciates more quickly than assumed. It may be said that Bob has suffered a loss, not necessarily because he derives less value from the car, but because he will be able to buy fewer *other* goods and services than expected.

On the other hand, assume the cost of operation for Carol, who owns a similar car, averages only $4,000 annually. Since the benefits from driving have not decreased (if anything, driving a trouble free car is more valuable), Carol has an unexpected gain of $1,000. Put another way, she has the ability, without any diminution of her enjoyment from driving, to buy an additional $1,000 worth of goods and services as compared to what she could buy if her car had an average repair record.

If the tax base is to reflect actual consumption, it should include the $1,000 gain to Carol and allow the $1,000 loss to Bob. Since individuals may take flawless performance for granted and certainly have no incentive to bring it to the attention of the Internal Revenue Service, such gains would be even

66. See Daniel Shaviro, The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption, 45 Tax L. Rev. 215, 232 (1990).

67. See supra notes 17-18 and 36.

68. The comparison is actual to expected costs, not higher cost of repairs on one make of car compared to another.

harder to measure and take into account than losses.

Medical expenses raise similar concerns. Some argue that a deduction for medical expenses, in excess of some percentage of gross income, is justified because such costs do not provide greater than expected consumption.[69] Like Bob, who does not get more than the normal benefit from his car despite the extra expenditure, such individuals are no healthier than average.

According to Andrews, "[t]he right basis for making interpersonal welfare comparisons ... is that ultimate object, good health, rather than the intermediate good..." medical services, which is not a proxy for good health.[70] If anything, the relation is apt to go the other way. "As between two people with otherwise similar patterns of personal consumption ..., a greater utilization of medical services by one is likely not to reflect any greater material well-being or taxable capacity, but rather only greater medical need."[71]

While it would be impractical to include good health directly, differences can be partially reflected by allowing a deduction for medical services that will be used more by those in poorer health. This approach "reflect[s] differences in health only as they manifest themselves in financial terms."[72] In other words, the best tax base would be money income plus some amount to take account of varying degrees of health, including disabilities encountered from birth. If the base is purely money income, those with poor health would be overtaxed. Since high medical expenses tend to reflect poor health, a deduction for such expenditures would be a proxy for taking account of such poor health directly.

Professor Kelman raises a number of objections to Andrews's argument.[73] He disagrees with Andrews's conclusion that expenditures on medical care are a good proxy for differences in health.[74] Essentially, Kelman believes that people with similar conditions spend different amounts or none at all on health care, reflecting to some extent general consumption desires.[75]

Therefore, a medical expense deduction *based on the nature of the injury or illness* would provide a better picture of differences in well-being. In other words, if B and C suffer from an illness while A is in perfect health, B and C can both be said to be less well off than A by an identical amount.

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69. Andrews, supra note 18, at 335-37.
70. Andrews, supra note 18, at 335-36.
71. Andrews, supra note 18, at 314.
72. Andrews, supra note 18, at 336.
73. Kelman, supra note 17.
74. Andrews, supra note 18, at 336.
75. Kelman, supra note 17, at 869-70.

B may choose to treat his illness with heavy medical expenditures while C perhaps does not need to because he has adequate insurance or would just rather console himself by eating and drinking well.

If one, nevertheless, concludes that excessive medical expenditures fairly reflect differences in well being which should be taken into account in determining the tax base, it would follow that individuals who are still able to enjoy good health despite expending significantly less than the average are, like Carol, able to enjoy unexpected additional amounts of other goods and services. Ideally, this would be taken into account if excessive medical costs are to be deducted. Again, however, this is unlikely to occur.

A similar problem arises with respect to what might be called "casualty gains"[76] which correspond to casualty losses for uninsured persons. Returning to Bob's $10,000 car, implicitly, the car must have an expected value of at least $10,000 even though there is say a 1% chance it will be totally destroyed in the very near future. A car which is not destroyed must then yield $10,101 of enjoyment.[77] In other words, $10,000 reflects the average expected value of all cars, not just cars which are neither victims of casualties nor lemons.[78]

Taxpayers who do not have an accident obtain $10,101 of automobile value for $10,000. The one driver in one hundred who suffers a casualty has a $10,000 loss. If this loss were allowed, the total consumption of the group would be undervalued unless each person who did not have an accident reported a $101 gain.[79] If neither gains nor losses are taken into account the group as a whole would report the correct taxable income.

Since it would be difficult to explain to taxpayers why a good repair record, excellent health, or avoiding an accident should result in taxable income, the type of gains just discussed will not, and perhaps cannot, be taxed. To the extent that losses and gains could be expected to be incurred by the same persons, as they would if some people systematically underinsure or take greater risks in their purchases, we might expect to more accurately measure individual consumption by outlays than if we tried to take outcomes into account. Indeed, the notion of allowing losses for such risk-neutral individuals while ignoring the noneconomic gains from such risky activity suggests that consumption is best measured by expenditures rather than outcomes.

Louis Kaplow reaches the same result by a different approach. He

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76. Kaplow, supra note 36, at 1502.

77. This is assuming there is no consumer surplus. A 99% chance of enjoying $10,101 equals $10,000.

78. It would seem that $10,000 is the expected value to the marginal risk-neutral purchaser. If an individual were risk adverse she might demand an expected value in excess of $10,000 in order to make the purchase.

79. Shaviro, supra note 66, at 241.

finds that if uninsured losses are deductible, individuals would be driven by the tax law to absorb more risk than desired.[80] Since the loss deduction provides free partial insurance, a taxpayer who chooses to insure and forego the free partial insurance pays for more than the additional coverage acquired. Therefore insurance may be rejected where it would otherwise be chosen. Because, all other things being equal, they would prefer to avoid the additional risk, if there is an opportunity to insure, individuals would *ex ante* uniformly prefer lower tax rates and nondeductibility of losses as long as the rate cut was such as to be neutral, on distributional grounds, compared to expected losses. In these circumstances, loss deductibility accompanied by higher rates would leave everyone worse off. Thus, Kaplow is able to find deductions for medical expenses and casualty losses undesirable without, he says, going through the type of exercise pursued in this article.[81] But it is important to recognize that the loss deduction would cause an undesirable change in behavior precisely because of the disparity between the treatment of uninsured gains, which would not be taxable, and uninsured losses, which would be deductible.[82]

2. *Only Selected Losses Will Be deducted.*—Federal income tax law has only taken account of medical deductions and losses due to casualty.[83] It is not clear what distinguishes casualty losses as defined in the tax law from other disasters. It may be that the requirement that the loss be "sudden, unexpected and unusual"[84] is essential to distinguish extraordinary occur-

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80. Kaplow, supra note 36, at 1500 n.68 & 1505.

81. Kaplow, supra note 36, at 1487. While he does not, at least initially, identify the failure to take account of gains to the uninsured as the culprit, at a later point in the article Kaplow, citing a draft of this article, notes the idea that a casualty loss deduction is asymmetric because it does not include in income what he refers to as casualty gain. Kaplow, supra note 36, at 1502.

82. If gains were somehow accounted for, deductibility of losses would not cause individuals to under insure. Thus, exploration of issues of income measurement helps explain, and thereby reinforces, Kaplow's conclusion.

83. Losses from bad debt on bona fide loans, not connected with a trade or business, are treated as capital losses. IRC § 166(d). It has been suggested that bad debts even from loans to relatives or friends reduce net worth and if repayment was genuinely expected, the loss should be deductible. Bittker, supra note 59, at 199.

It seems to me, however, that in many circumstances, a potential gift was contemplated. For example, a taxpayer may loan $10,000 to a relative, and while repayment is expected, he believes there is a 20% possibility that default will occur. While it is possible that the interest rate is high enough to compensate for the potential default, and the loan would be made by the taxpayer to a stranger under similar circumstances, it seems more likely that there are personal motivations and the taxpayer may well be willing, perhaps without explicitly thinking about it, to make a gift with an expected value of $2,000. When the "gift" turns out to be $10,000 instead, would there be an argument for an $8,000 loss? If so, is there $2,000 of income if the loan is repaid and the gift becomes costless?

84. See Rev. Rul. 72-592, supra note 8.

rences from normal wear and tear. According to Kelman, however, casualty losses resemble other disappointments with purchased commodities.[85] Automobiles that are "lemons" may involve as big a loss from expected return as those which suffer a fire.[86]

Professor Kelman also finds it hard to distinguish health from other psychic pleasures. He believes that it is not plausible that taxpayers differ in health far more than they do in other forms of well being, such as untreated depression, bad marriage, or a boring job.[87] In fact, these other conditions, unlike poor health, are more likely to be inflicted on the poor. Therefore, it is not appropriate to take account of decline in health without also comparing other noneconomic attributes.

In this connection, this article would be remiss and out of step with much of the recent tax scholarship if it did not refer to *Zarin v. Commissioner*.[88] As probably every reader of this article well knows, Zarin lost over three million dollars gambling with chips furnished him on credit by a casino. When the debt was settled for one-half million dollars, the Internal Revenue Service charged Zarin with discharge of indebtedness income for the difference. Zarin lost in Tax Court but eventually won on appeal.

Of concern to this article is whether Zarin has a loss equal to the difference between what he spent and the presumed enjoyment derived from gambling.[89] As Daniel Shaviro has pointed out, given the amount of money and time Zarin devoted to gambling (huge sums, twelve to sixteen hours a day, over a period of several months), it is likely that his actual losses coincided with the amount he should have expected to lose.[90] Therefore, the only argument for a loss deduction would be that because he was a compulsive gambler, Zarin's actual enjoyment was much less than even the expected

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85. Kelman, supra note 17, at 860 n.87; see Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 34.2 (2d. ed. 1989) (listing of significant losses which have been denied as not attributable to casualties).

86. Professor Kelman also believes that casualties are more likely to be evenly distributed than "bad buys," which the poor are more likely to make. Kelman, supra note 17, at 860 n.87. As discussed above, vertical equity may not be a concern, however. See supra note 57 and accompanying text.

87. Kelman supra note 17, at 869.

88. Zarin v. Commissioner, 92 T.C. 1084 (1989), rev'd, 916 F.2d 110 (3d Cir. 1990); see Babette B. Barton, Legal and Tax Incidents of Compulsive Behavior: Lessons From *Zarin*, 45 Tax Law. 749, 749-50 nn.4 & 7 (1992) (*Zarin* is "widely celebrated" in law school texts and legal commentaries).

89. Perhaps more important is whether Zarin has a non-taxable recovery, regardless of whether the loss is recognizable. Again, however, this presupposes a loss. But if Zarin achieved full value from his gambling there is no loss to be recovered. Therefore, the issue remains the same—should Zarin's mental state be taken into account in determining the value derived from gambling?

90. Shaviro, supra note 66, at 233.

cost.[91] Even if an *ex post* approach to consumption were to be adopted, it is unlikely that such subjective feelings, as opposed to differences in outcome which could be objectively measured, would be taken into account.[92]

This reinforces the conclusion that a tax base which ignored losses could be fairer than one which took account of only some losses, such as casualties and medical expenses. This would be particularly so if losses of all types combined tended to be fairly evenly distributed.

D. *Lost Paycheck*

The previous sections in this part suggest that *ex post* measurement should be approached with extreme caution, if not actually rejected. Still, in limited circumstances, we need not measure consumption by the amount of income earned. Some who generally prefer an *ex ante* measurement would favor a deduction for a taxpayer who suffers the loss of his paycheck on the way to the bank. This income may be viewed as never effectively received or appropriated and, therefore, equivalent to never having been earned in the first place.[93]

Of course, the reasons that cause us not to base income on earning capacity do not apply once income has been earned. The amount earned is measurable, and no one has been forced to work in order to meet his tax liability. Still, one who is sympathetic to an *ex post* result but is concerned about the measurement problem might allow losses to reflect a stolen paycheck, or perhaps misplaced cash in general, even if they ordinarily disregarded losses once consumption took place. In this view, a taxpayer whose paycheck is stolen gets no benefit from the transaction and should be entitled to a deduction.[94] Putting aside problems of proof as to whether a loss actually

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91. Cf. Shaviro, supra note 66, at 236-39.

92. Shaviro, supra note 66, at 225. If one is sympathetic to Zarin's cause, as most seem to be, it seems a better course to argue he never purchased more than $500,000 worth of chips because the casino's course of conduct made it impossible to enforce the debt. Shaviro, supra note 66, at 244. While such a bargain purchase, if it occurred, would not be treated as income, this description of events may be hard to accord with the facts. Barton, supra note 88, at 762-65. However, one way to view the settlement is as a purchase price adjustment, analogous to IRC § 108(e)(5). Shaviro, supra note 66, at 249.

93. See Kelman, supra note 17, at 859 n.87; William Andrews, Basic Federal Income Taxation 519 (3d ed. 1985).

94. An analogous situation may arise in the case of a taxpayer who erroneously overpays her income taxes. In this case, like the loss of cash, the amount the individual can actually spend on consumption is less than would be expected based on the income earned. In the next section, at note 126, I consider whether taxpayers who recover from an accountant or other person who caused an excessive income tax to be paid can exclude that recovery from income. If the exclusion is allowed, should a taxpayer who is unable to recover be entitled to a deduction to recognize, as in the lost paycheck case, that his income does not fairly reflect

occurred, the amount of the loss, since it is money, can be measured and it is unlikely that the person suffering the loss would have unreported gains of a similar type.

Nevertheless, it could be that the loss of a paycheck or theft of cash is a result of a life-style choice, just in the way that some see many medical expenses. For example, the taxpayer may lose his paycheck when he stops in a bar on the way home from work. Further, allowing this type of loss and not others could be viewed as favoritism toward some taxpayers.

E. *Sale of Assets Held for Personal Use*

Despite the general adoption of an *ex ante* approach to measuring consumption, there is no question that if an automobile or a boat is voluntarily sold in a market transaction, gain, if any, will be taken into account. We need to consider whether it is the sale, which makes such gains measurable, or whether there is some other attribute that distinguishes this case from an absolutely wonderful dinner, perfect weather during vacation, or an extraordinarily exciting baseball game, all of which might be worth more than the price paid.

It must be recognized that regardless of how consumption is measured, *income* would be determined according to how things turned out, rather than by expectancies.[95] A lottery ticket purchased for one dollar probably has an expected value of less than fifty cents, but the winner of a forty million dollar jackpot will be taxable on the forty million dollars. In measuring income, *ex post* results count not *ex ante* expectations.

But if we are to take account of actual outcome with respect to income but only expectancy as to consumption, it is necessary to clearly draw a line between the two activities. This may not be easy.[96] Many consumption purchases have an investment aspect. The purchase of a residence, an automobile, fine wine, art, or jewelry is in many ways an investment similar

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his spending power?

95. See Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1601 (1979).

96. As Simons puts it:

> Consumption, presumably, should be measured in terms of values at the time of consumption; but to ignore changes in value between time of purchase and time of use will ordinarily make very little difference. The difference might be large, of course, where a man purchased choice beverages and allowed them to acquire the quality and distinction of ripe age.... At all events, there is suggested here the difficult question of where to draw the line between acquisition of means and their employment. At what point shall the idea of gain or loss be dropped. One finds no ready answer....

Simons, supra note 1, at 119.

to the purchase of a stock or bond. With respect to items such as artworks and jewelry, and perhaps a residence as well, a purchaser would often count on appreciation to provide a return on his "investment" in addition to the imputed income from use. Whether or not this is the case, with respect to consumer durables it should be explicitly recognized that the true element of consumption is the value of the use of the item and that the purchase is in effect an investment.[97] Unlike a ball game, dinner or vacation the consumption value of more durable items still exists in the future, and it is possible by sale to switch one's consumption to other items. This is hard or impossible to do for most items of consumption. When appreciation occurs, the ability to shift consumption to another form seems to reflect increased market power to consume and not merely the level of enjoyment from purchases after the fact.

Therefore, it would be appropriate to take gains on consumer durables into account even if unrealized. As Richard A. Epstein has noted, it appears to be the realization requirement and not the *ex ante* approach that keeps this from happening.[98] This impact of the realization requirement is particularly troublesome because the result is exemption rather than, as is the usual case, deferral.

Exemption could extend to even realized gains under present law. Because we do not adjust basis for depreciation[99] there is gain on sale only if the selling price exceeds the original cost. Apart from residences, where gains are most often deferred and eventually forgiven, and art and other collectibles, which generally do not depreciate, appreciation over the original cost with respect to consumer items would be extremely rare. But, if we adjusted basis for depreciation, which we should do whether or not depreciation is deductible, gains upon sale would be more common.

Apparent gain would reflect not only changes in market price but such variables as better than average quality or lower than average wear.[100] In the latter case, however, if depreciation were properly measured, there would be no gain to report. For example, assume Agnes's automobile costs $10,000, should normally last five years and decline in value at the rate of $2,000 a year. After three years of use Agnes sells her car for $5,000 or $1,000 above the depreciated basis of $4,000. The gain could reflect a rise in market value (overall good quality) for automobiles of that vintage, recognition, based on repair record or otherwise, that Agnes owns a better

97. Joseph A. Pechman, The Brookings Institution, What Should Be Taxed: Income or Expenditure? 94 (ed., 1980).

98. Richard A. Epstein, The Consumption and Loss of Personal Property Under the Internal Revenue Code, 23 Stan. L. Rev. 454, 457 (1971).

99. IRC § 167.

100. See Graetz, supra note 95, at 1617.

than average car,[101] or merely the fact that Agnes has driven fewer than average miles.

If, however, depreciation in the value of an automobile reflects not only the period of ownership but also the level of use and care, in the last case the adjusted basis of Agnes's automobile should not be $4,000 but rather should be $5,000 to indicate that depreciation over the three years of use was less than the $6,000 expected. Put another way, Agnes did not get 60% of the expected use of the automobile over the three years that she owned it; more than 40% was saved for the future. She had only $5,000 of use and $5,000 of cash from her original $10,000 expenditure, and consequently she had no gain.[102]

Professor Epstein recommended allowance for losses as well as taxation of gains on transfers of consumer durables and residences (after properly adjusting basis for depreciation).[103] Whether allowing a loss is appropriate would again seem to depend on the reason why the loss was incurred.[104] In addition to the possibility of a decline in market value for automobiles of that vintage, a loss could reflect the fact that the car had been damaged in an accident or is known to have suffered above average repairs or just is not running as well as it should. All these events could reflect additional consumption on the part of Agnes from more than average mileage or from a style of driving or of care for the car (leaving more time for other

101. It is unlikely that the used car market would recognize Agnes's better than average car. Because fraud often goes undetected in the used car market, consumers cannot differentiate between good and bad cars. Thus, the rational consumer assumes that all cars are of average quality, and the seller, without a method of proving the superior quality of his automobile, has little choice but to ask the average price for the car. Eventually, better than average cars will not be available in the market, the average quality will decline, and the price which consumers are willing to pay for a car of unknown quality will be reduced. The cycle will repeat itself driving owners of average quality cars out of the market. David M. Green, Comment, Due Diligence Under Rule 415: Is the Insurance Worth the Premium?, 38 Emory L.J. 793, 818 (1989). See generally Akerlof, supra note 4.

102. If the reduction in the rate of depreciation is due to diligent care and use, it may be reflected by maintenance expenditures. This is not to suggest that depreciation charged should be directly related to maintenance costs. Large repair records could reflect accelerated wear and tear, not prevention of depreciation. In the absence of a method to distinguish between expenditures made to prevent depreciation and those made because of depreciation, there may be no objective measurement other than mileage (which would not be entirely accurate) to adjust depreciation to reflect actual wear.

103. See generally Epstein, supra note 98.

104. It has been suggested to me that loss allowance is inappropriate as long as imputed income from use is not taxed. It is not clear that the two are necessarily related. I note that gains and losses on the sale of state and local bonds are taken into account even though interest income is exempt. It seems to be true, however, that if imputed income were taxed, it could reflect an increase in the value of the car or a better than average repair record depending upon how the amount of imputed income was computed.

pursuits) which led to excessive deterioration or even a major casualty.[105]

If the loss occurred because Agnes drove greater than the expected number of miles or failed to properly care for the car, allowance of a loss would be clearly unjustified, as would recognition of gain in the converse situation. If the loss was not a result of Agnes's behavior, however, recognition might be appropriate.

One problem with recognition of such losses would be the adverse selection that would occur from taxpayers selling assets which have declined in value and holding on to those which have increased. In fact, more frequent sales of items of low quality might occur even in the absence of such a tax incentive. Even if realization were not required, comfort with loss recognition might depend upon whether we would be able to identify comparable gains because a particular car was better built than average or gratuitously had a better than average repair record.[106]

In sum, even under an *ex ante* approach, gains on sales of consumer durables are taken into account. It would be appropriate, moreover, to recognize gains even in the absence of realization. In theory, an exception should be provided for gains that are a result of less than average use but it seems difficult to separate such gains from market changes. Furthermore, perhaps such gains do not occur often enough to be worth the trouble, if, as is suggested above, the market does not readily distinguish between a particularly good used car and an average one.[107]

While symmetry might require deduction of losses, particularly if attributable to a market decline, a number of concerns arise. If realization is required, it seems losses would be much more likely to be recognized than gains. Again, even though the existence of a declining market could be objectively documented, it seems impossible to separate and disallow "losses" that reflect higher than average consumption in the particular case, and it may be that it is these items which are most likely to be sold. Moreover, even where extra consumption is not present, losses, because a particular item has performed below average, are comparable to gains for those whose "costs" are below average. Since discovering unrealized gains of this type is difficult, loss recognition would seem likely to systematically understate total income

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105. As Professor Kelman has noted, above average medical expenses can also be the product of lifestyle—smoking, drinking, or engaging in other activities that are inherently dangerous, such as skiing. Kelman, supra note 17, at 869.

106. There may be, for example, a number of 3-year old cars worth more than $4,000 (or more than the average market value of that model at that age). Even if realization were not required, how would such gains be discovered?

On the other hand, cars which suffer a casualty or are otherwise lemons are more likely to be sold. See generally, Julie A. Vergeront, Note, A Sour Note: A Look at the Minnesota Lemon Law, 68 Minn. L. Rev. 846 (1984).

107. See supra note 101 and accompanying text.

for society as a whole.[108]

If allowance of losses is unwise, as I believe it is, the question is whether recognition of gains alone, perhaps even if unrealized, produces a better tax base than if both gains and losses are ignored. The above discussion suggests that ignoring gains because we cannot allow losses is better only if those who have gains are also more likely to have losses. There should be some correlation to the extent gains and losses arise from the ownership of particular assets or a penchant for more risky purchases. Nevertheless, since the losses involved here do not necessarily arise from failure to insure, matching of gains and losses is somewhat less likely.

Moreover, as a matter of equity, or at least perceived equity, there seems to be little difference between an investment gain in the stock market and an increased net worth due to appreciation in the housing market. Certainly with respect to art, we could not exempt gains merely because a taxpayer designates the item as purchased solely for personal use. Since I believe that gains must be included in income and that allowance of losses could be abused, I am forced to grasp for a way to distinguish losses due to a decline in market value of consumer durables and residences from other investment losses.[109]

Consider that it may not be possible, even in the case of a market decline, to identify the true amount of consumption derived from housing. For example, assume an individual purchases a new residence for $100,000. Assume, for ease of exposition, that the property is not expected to depreciate during the first year.[110] The expected cost, and therefore consumption value of the house, at a 10% interest rate, would be $10,000 a year which is the imputed income from home ownership or the loss of income from withdrawing $100,000 from other investments.[111]

If at the end of the year the residence were sold for $95,000, is the $5,000 decline an investment loss, or can it be considered an additional cost of consumption? Assume the owner would have been willing to pay $16,000 per year to live in the house. While the $6,000 premium over expected cost would normally be considered consumer surplus, is it possible to consider at least $5,000 of this amount as an additional cost of consumption when the

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108. More precisely, loss recognition would underestimate total value of goods and services.

109. The House has recently passed a provision allowing losses on sale of a principal residence to be carried forward and allowed against future gains. In effect, the purchase price of the new residence would be increased by the disallowed loss on the sale. See, Barbara Kirchheimer, Archer Real Estate Measure Called Harmless Enough To Win Passage, 56 Tax Notes 254 (July 20, 1992).

110. I am ignoring inflation and possible incentive depreciation in order to assume that depreciation is intended to reflect actual decline in value.

111. Under current law this imputed income is not subject to tax.

surplus in fact does not materialize to that extent?[112]

The converse of this argument could not be used to justify exclusion of gain. For example, suppose the residence sells after one year for $105,000. The owner cannot as easily argue that his true consumption was only $5,000 because if this is the expected value he attached to the residence, he would not normally have purchased it. For him to have done so, he would have had to have believed that the market was wrong. The owner who valued the use of the home above expected cost would have purchased the home in any event. Thus, while this point does not have overwhelming force, it offers some justification for asymmetrical treatment of gains and losses which appeals to me on other grounds.

F. *Conclusion*

In sum, the case for *ex post* as opposed to *ex ante* measurement does not seem strong enough to warrant taking on the additional administrative difficulty. There should be little difference in most cases especially if gains on housing and consumer durables are properly accounted for. Moreover, much of what appears to be losses actually reflects increased consumption or preference for leisure. Further, the theoretical advantage of taking account of actual differences in enjoyment seems to be considerably weakened to the extent that unfavorable outcomes are the result of failure to insure or other voluntary action. Finally, particularly because gains are hard to identify, any attempt to measure outcomes may fall shorter of the goal than if the effort were not made.

IV. TREATMENT OF RECOVERIES

The previous part of this paper has considered whether a taxpayer who experiences less than expected enjoyment from an expenditure should be entitled to a tax deduction for this "loss." We turn now to the treatment of those luckier individuals who would have suffered such a decline in enjoyment but for their ability to "recover" from someone else such as the seller of the product, an insurance company or a tortfeasor.

At first glance, it may appear to be obvious that such recoveries would be tax-exempt regardless of the approach favored for the treatment of those who cannot recover for their losses. If the tax base were income or power to consume, consumption would be measured *ex ante* by the amount expended in the purchase of goods or services. Outcomes would be irrelevant.

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112. Some may consider it relevant that the $10,000 of imputed income was not included in income. See supra note 104. A similar argument could be made for not treating the excess of the actual over the expected cost of any consumer purchase as a loss.

Under this approach the value of insurance or a dealer warranty could be said to be the price or premium charged, whether or not the taxpayer recovered on the policy. The purchaser who insures has merely acquired a more "reliable," and hence a more expensive product, no different than if she had purchased a better quality model. In short, there is no "recovery."

Those who prefer a tax base equal to actual consumption would care how matters turned out. But the purchase of insurance or other protection is, ostensibly at least, to protect the consumer's expectancy. Unlike the uninsured, the insured experiences no difference between such expectancy and actual enjoyment. For example, if property is damaged or destroyed, insurance will replace it. Therefore, there is no reason to tax any recovery.

I believe, however, that while this conclusion might be at least generally correct, the explanation is not quite that simple. As we have seen, even under an *ex ante* approach, the consumer who transfers what might be considered an item of consumption, such as an automobile, will be taxable to the extent that the amount recovered exceeds her basis. Proceeds in excess of basis may be taxable whether or not the seller's position is improved. For example, an amount received in return for permission to violate an individual's right to privacy would be taxable even though such an individual could be said to be no better off.[113] In the case of an insurance or other recovery, the recovery measured *ex post* will exceed the cost of the protection which cost might appear to be the taxpayer's basis.

Ultimately of course, it might seem unfair to include the recovery in income without allowing a deduction for the loss which the recovery reimburses. But this justification for the exclusion of recoveries appears inconsistent with no deduction for uninsured losses. In short, how can we justify similar tax treatment for two individuals who seem to be in different positions in that one recovers for her loss and the other does not?

Therefore, while tax exemption for insurance or warranty recoveries does seem appropriate under either an *ex ante* or *ex post* approach to measuring consumption, such exemption is not easily explained. After considering a number of possible justifications, one can better understand the possible limits of such an exemption.

A. *Basis Recovery*

1. *In General.*—Even voluntary transfers would not be subjected to tax if the amount received did not exceed the taxpayer's basis. For example, if an automobile which cost $50,000 were sold for $30,000, there would be no tax on the transaction. As we have seen, this treatment is incorrect to the extent that the owner's basis is not reduced to reflect depreciation over the

113. Kelman, supra note 17, at 842-43.

period of use. If, however, proper depreciation did not exceed $20,000, tax exemption of the proceeds would be appropriate.

Some have noted a potential discontinuity if basis is taken into account for the purpose of excluding the proceeds of sale, but not for the purpose of allowing a loss.[114] In that connection, we have discussed previously whether a deduction for a loss would be appropriate if an automobile were sold for less than its basis after properly adjusting for depreciation.[115] However that question is determined, it is inappropriate to tax proceeds which are not in excess of basis. Thus, for example, suppose the automobile purchaser immediately changed her mind and was able to sell the new car for the original $50,000 purchase price and buy a boat instead. It would seem to be clearly wrong to include the $50,000 from the sale of the car in income. Total consumption remains at $50,000, even though it is shifted from an automobile to another form. As long as the taxpayer receives no more than her basis, consumption does not increase and neither should taxable income.

In the case of insurance or seller warranty, however, the very purpose of the transaction is to pay a small, fixed amount up front to protect oneself against the possibility of a very large expenditure later on. While the taxpayer may seem to be no better off when the insurer or seller makes good after a "disaster" occurs than she would have been if all went well, an exclusion may not be explainable on the grounds of basis recovery. The essential nature of insurance is to pay a little for a large amount of protection.

2. *Is Basis Essential?*—Under one view, the fact that the individual is no better off is sufficient without regard to whether there is "technically" enough basis. Andrews notes that the exclusion of medical services provided by a charity or by a government welfare program or by a tortfeasor has not been considered to be a tax preference.[116] He suggests this is because "[t]he taxpayer is no better off after the whole transaction than before he incurred his injury and it would be unnatural to view the provision of medical services in isolation from the injury as producing a taxable gain."[117]

There are difficulties with this approach, however. It is not consistent with the treatment of taxpayers who are taxable on a sale of rights, such as privacy, even though they would not appear to be better off.[118] In addition, as Andrews notes, it may follow from his premise that a taxpayer who pays for his own treatment should be allowed a medical expense deduction to

114. See, Lawrence Zelenak, The Taxation of Indemnity Payments: Recovery of Capital and the Contours of Gross Income, 46 Tax L. Rev. 381, 389 n.43 (1991).

115. See supra text accompanying notes 98-106.

116. Andrews, supra note 18, at 334.

117. Andrews, supra note 18, at 334.

118. Andrews's view would also suggest that wages would be exempt to the extent leisure is lost.

reflect the fact that he is worse off than either a taxpayer who does not get sick or one who is reimbursed for his costs.[119] While a deduction is allowed for medical expenses in excess of 7.5% of adjusted gross income, as we have seen, losses are generally not allowed.

Some would avoid these difficulties by asserting that it is only when the transaction is involuntary that it is unfair to tax an individual who ends up no better off. Noting that we *do* tax a person who voluntarily markets his privacy rights, even while we exclude tort recoveries for violation of privacy,[120] Kelman sees the distinction between voluntary and involuntary action as "a political recognition of a basic human resistance to commoditization."[121] According to Kelman, the tax system must confirm a person's refusal to treat his privacy as a saleable object.[122] It is the involuntariness of the conversion that bars taxability.

Others are not sure. Griffith suggests that once a taxpayer's rights have been violated, imposing a tax on the proceeds does not necessarily add to the injury.[123] If the injured party is worse off because he is forced to substitute taxable dollars for an untaxed benefit, perhaps the recovery should have been increased so as to make him whole.

Further, when the tax law specifically waives current tax on insurance proceeds under section 1033, it conditions the exemption for the amount received in excess of basis on reinvestment in similar property.[124] The presumed need for section 1033 may indicate that in the absence of basis, involuntariness does not necessarily make a recovery nontaxable, or at least that exemption should be conditioned on reinvestment in similar property.

3. *Does Basis Exist?*—Assuming sufficient basis is a prerequisite to exclusion of proceeds, to what extent can it be said that there is adequate basis in the transactions we are considering? If instead of comparing the insurance proceeds to the premium, we could compare the proceeds to the full original cost of the insured purchase, as if the item were sold to the insurer, the recovery, in some instances at least, may be said not to exceed basis. Thus, an individual whose car was stolen or totally destroyed would be likely to have a basis in the car at least equal to the amount recovered from insurance or the tortfeasor who caused the damage.

Something analogous to basis recovery occurs when a taxpayer merely gets her money refunded. Consider, for example, a resort which has

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119. Andrews, supra note 18, at 334.

120. See IRC § 104(a)(2).

121. Kelman, supra note 17, at 842. Kelman rejects the notion that the non-taxability of tort judgments supports the medical expense deduction.

122. Kelman, supra note 17, at 843.

123. See Griffith, supra note 24, at 381.

124. IRC § 1033(a)(2).

a policy that reimburses 80% of the cost of the hotel if it rains more than 50% of the time during a week's stay. A refund from the hotel would clearly seem to be nontaxable, even if the refund technically might not amount to a recovery of basis.

This approach could possibly extend to "refunds" from a third party. For example, an insurance company might contract to "refund" the cost of a vacation in the event of excessive bad weather. The Internal Revenue Service has accepted the tax free status of tax indemnities from tax counsel who erred in return preparation.[125] After filing a joint return on the advice of their accountant, Mr. and Mrs. Clark later learned that their tax liability would have been almost $20,000 less had they filed separate returns. Their accountant admitted his error and reimbursed the Clarks for the additional liability. The Internal Revenue Service acquiesced in the non-taxability of such a recovery.[126]

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125. Clark v. Commissioner, 40 B.T.A. 333 (1939), acq. 57-1 C.B. 4; Rev. Rul. 57-47, 1957-1 C.B. 23.

126. Id. Before it recently reversed its position, the Internal Revenue Service also agreed to exemption for tax indemnity payments received from a transferor of assets who guaranteed that the purchaser would be entitled to certain tax treatment. G.C.M. 39697 (Jan. 27, 1988) withdrawn, G.C.M. 39857 (Aug. 15, 1991). In one case, a contracting party failed to live up to his promise that interest from the package of mortgages transferred would earn a tax credit under IRC § 936. Priv. Let. Rul. 8748072 (Sept. 3, 1987). In another case, the transferor under a safe-harbor lease had represented that all the property was "qualified lease property" when in fact some of it was not. This led to a denial of an expected investment credit and depreciation deduction. Priv. Let. Rul. 8923052 (Mar. 16, 1989). General Counsel Memorandum 39697 appears to argue that if the taxpayer had paid the lower tax it legitimately expected to pay, it would have been able to retain the excess cash without additional tax. Therefore, the same result should follow when the cash is recovered from the contracting party.

After first withdrawing the earlier ruling, Priv. Let. Rul. 9014404 (January 5, 1990), the Internal Revenue Service has now reversed its position, Priv. Let. Rul. 9226032 (March 26, 1992) and Priv. Let. Rul. 9226033 (March 26, 1992). The Service reasoned that unlike Clark, the taxpayers involved in the private rulings had paid the proper tax under the facts as they existed. Amounts received from a third party to offset such tax payments are taxable under the principle of Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

The Internal Revenue Service's action has been criticized. William L. Raby, IRS Change of Position May Up the Cost of Tax Malpractice, 56 Tax Notes 195 (July 13, 1992); Lewis M. Horowitz, Excludability of Tax Indemnification Payments Threatened by Recent Change in IRS Position: PLR 9014046, 49 Tax Notes 799 (Nov. 12, 1990). Professor Zelenak, however, agrees with the Service. He points out that if the earlier position had been maintained, a corporation might be able to represent that the interest on its bonds is tax-exempt. It could then claim that the additional payments it must make when the representation turns out to be false are non-taxable tax indemnity payments as opposed to taxable interest. Zelenak, supra note 114, at 398-99.

It may be, however, that the issue is more complex. Suppose, if proper advice had been given, adverse tax consequences could have been avoided without changing the

No matter how far the concept can be expanded, however, basis recovery will not suffice as an explanation whenever an individual pays a small amount for protection against a potentially large future cost. Examples would include the value of repairs under a dealer warranty,[127] a regular airline ticket provided to a traveler unable to make the return flight by charter,[128] and payment by an insurance company of a judgment entered

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economics of the transaction, or in Priv. Let. Rul. 8748072 (September 3, 1987), other mortgages were available that had not been purchased by taxpayers seeking benefits under IRC § 936.

127. The basis in the original part may not be sufficient particularly if depreciation were required.

128. Assume a charter flight is available for $1,000. If the traveler cancels, the ticket price is non-refundable. If she is stranded overseas, and is unable to make the return connection, a regular ticket will cost $800. Assume the traveler will value the trip at $1,100. Her calculation of whether it makes sense to purchase the charter ticket will be as follows:

	Percent Chance	Expected Cost	Expected Value
Charter Both Ways	90%	$ 900	$ 990
Charter One Way	5%	90	55**
Trip Canceled	5%	50	0
		$1,040*	$1,045**

If the expected cost is less than the expected value, the charter flight is a sensible purchase as shown. But the risk-adverse traveler may be unwilling to make the purchase since there is a 10% chance of a substantial loss. Even a risk neutral person would find the trip inadvisable if the risk of a separate return increases to 6% which would increase the expected cost to $1,048. She may, however, be able to purchase insurance for, say $90, which will reimburse the cost of the charter flight if she cannot make the trip, or supply a return ticket if she is unable to make the return flight. If the insurance is purchased, the calculus is as follows:

Expected Cost		Expected Value
95% x $1,090 =	$1,035.50	95% x $1,100.00 = $1,045
5% x $90 =	$ 4.50***	
	$1,040.00	

Viewed from an *ex ante* perspective, the insurance is worth no more than $90 and the value of the ticket and the insurance is worth no more than $1,090. What should be the result if the insurance provides reimbursement of $1,000 or if it pays the cost of a return flight, $800?

* The expected cost is $1,000 (the cost of the charter) + $40 (the expected cost of the return flight for the "stranded" traveler) (5% of $800) = $1,040. In other words, the cost is $1,000 for charter whether canceled or not and an additional $800 when there is a separate return, which has a 5% chance of occurring.

** The expected value is 95% of $1,100, assuming a separate return does not indicate a reduction in value of the trip. This may not be true if, for example, the traveler returns early because of illness.

against a driver held liable in an accident.

The recovery reimburses the insured against a cost that she would otherwise have to incur. But to claim this is merely a refund of that outlay, which in many cases will not actually occur, seems to stretch basis recovery beyond recognizable limits. In fact, this suggestion seems more like an argument for recovery of a loss.

In sum, basis recovery cannot explain exclusion of all recoveries. In fact, since the value of the recovery measured *ex post* clearly exceeds the amount paid for the protection, basis recovery may not in general be a good explanation for exemption for insurance, warranty or tort recoveries. Another justification for non-taxation of insurance recoveries would be needed to deal with situations where basis is insufficient.

B. *There Is No Recovery*

The question of whether a recovery is taxable could be avoided if we can determine that there is in fact no recovery by the taxpayer. An individual who insures or obtains a warranty purchases a different product, since she now has a one hundred percent chance of full enjoyment for the price paid. The difference in value of the two items is merely the cost of insurance. The cost to the insurance company or the seller should be irrelevant.[129]

For example, an automobile has an expected cost of operation which includes the initial purchase price, the cost of gasoline and repairs, and potential liability to injured parties. One presumably measures this expected cost against the expected value in determining whether to make the purchase. But there is a risk that the actual cost might be greater than expected. Insurance (or a seller's warranty) merely guarantees that actual cost of operation will be closer to expected cost. Thus, once the premium is paid for insurance or a warranty, the purchaser is out of the picture. Her cost of operation is fixed.

In a sense, this is just another way of explaining the *ex ante* approach. Value is measured by the cost in a market transaction, here the sum of purchase price and insurance. As described above, however, the *ex ante* approach does not preclude taking account of gains on consumption items whenever there is further market transaction, for example a sale of a residence which would enable the taxpayer to substitute a different form of consumption. In the situation we are now concerned with, there may be a

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*** If ticket price is reimbursed when the traveler must cancel, expected cost is $90 (insurance) + $950 (95% of $1,000 cost of ticket).

129. Kaplow, supra note 36, at 1500-01 n.68 (citing an earlier draft of this article). Professor Kaplow compares an insurance company to a lessor that promises to make an asset available regardless of whether a casualty occurs. Kaplow, supra note 36, at 1501 n.68.

gain in the sense that the recovery exceeds the cost of the insurance or warranty. Nevertheless, while the recovery does provide, in some sense at least, a market transaction, it does not necessarily permit such consumption to vary.

In the case of a seller warranty, there is no opportunity to alter the form of consumption. A vacationer who can stay an extra, hopefully less rainy, week at a resort which provides this option when there is excessive rain during the initial week, or a car or television set owner exercising his rights under a product warranty can in no way change the mode of consumption. They are merely enjoying the original purchase, a working car or television set or a week of good weather, at the *agreed upon price*, which price, because of the seller's warranty, was higher than it otherwise would have been. It is immaterial that the vendor's costs with respect to a particular buyer may exceed the price paid.

In the case of payment of liability by an insurance company, one of the costs of operating an automobile, the potential liability to injured parties, has been "purchased" at a fixed price. That price has not changed nor can the money be used for any other purpose. The insurance company pays the injured party directly.

The analysis is more strained in the case of a charter flyer, who is stranded in Europe because she is unable to make her return flight. Her insurance may provide her with cash in lieu of a return ticket. Although she receives cash, she is likely to have little discretion in how to use it.

In any event, this approach would not explain all situations. If, when it rains, the vacationer gets her money back from the resort rather than an additional week, she clearly has money which could be used for other pursuits, as does the driver who recovers when an automobile is destroyed by a collision. While in these cases there may be said to be basis equal to the amount of the recovery, exemption cannot be explained on the grounds that the consumption choice remains unchangeable.

In other situations the original form of consumption cannot be maintained. An individual whose privacy is violated is reimbursed in dollars rather than in restored privacy. In the event of a fire that makes a residence unusable, the insurer provides cash to meet additional expenses incurred as a result of being denied access to the residence. The insured becomes a renter, not a home owner. Thus, once again we have an incomplete theory for exemption of recoveries.

C. *Deduction for Insurance Premiums*

There may be another way to explain exclusion for certain recoveries. It is arguable that if insurance or warranty proceeds are properly taxable, the premium or cost should be deductible. Taking account of neither is simpler,

in part, because it alleviates the need for additional insurance to cover the tax liability.[130] It is also revenue neutral if we can assume similar marginal rates would apply to deduction of premiums and taxation of proceeds.

The premise is that if the value of insurance must be measured *ex post* to produce gain to those that recover, the value would have to be similarly measured for those that do not suffer a loss. If the value in the latter case is zero,[131] there would be a loss. If this loss is deductible, the insured, except for the impact of progressive rates, could, at the same net cost, provide additional insurance to cover the tax liability on the recovery. For example, assume an individual could purchase $100 of insurance for $1 to protect against a potential $100 loss. If the proceeds were taxable, at a 28% marginal rate, he would need $138.80 in insurance to have enough left after tax to cover the loss, but this would still only cost $1 if the premium ($1.39) were deductible. The net cost to a person who does not suffer the loss would be $1 whether one adopted the premium ($1.39) deductible and proceeds taxable or the premium ($1.00) nondeductible and the proceeds nontaxable approach.

The identity disappears if we take account of the insurance company's expenses, investment income[132] and profit or loss on the transaction. If, taking these factors into account, the payout exceeds the premiums collected, clearly the revenue suffers if neither the premiums nor the proceeds are taken into account in determining the insureds' taxable income. On the other hand, it is much more likely that, in the long run, premiums will exceed the proceeds in order to cover the insurance company's expenses and provide a profit. When both gains and losses are excluded, this "loading charge" is effectively not deducted by the policy holders.

This fact, as well as the effect of a change in tax rates, indicates that there would not necessarily be an identity between the two approaches considered in this section. This makes it necessary to consider further which approach is more appropriate.

To the extent progressive rates are intended to reflect greater ability to pay, they would seem to be misapplied to loss recoveries which replace other expenditures. Moreover, it would be burdensome if taxpayers had to predict the applicable tax rate in order to determine the adequacy of insurance. Professor Kaplow has also noted a potential for serious moral hazard

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130. Kaplow, supra note 36, at 1501.

131. This assumption is questionable. See infra p. 37.

132. The discussion generally assumes insurance against a contingency which will or will not occur instantaneously. If there is a delay, the insurer will invest the premiums and earn investment income. Ideally this investment income should be taxed to the insured. See generally Daniel I. Halperin, Interest in Disguise: Taxing the Time Value of Money, 95 Yale L.J. 506 (1986). This matter will not be pursued further in this article.

if a drop in marginal rates caused a taxpayer to be over-insured.[133] This may suggest that even if it were theoretically more correct to allow a deduction for premiums and impose a tax on recoveries, it could be better to do neither.

Moreover, the latter approach may in fact be more appropriate. As noted above, exclusion of the proceeds is not equivalent to a deduction for the premiums to the extent that the premiums exceed the proceeds. However, since to the extent of the loading charge the insured pays more than the expected value of the purchase in order to avoid the possibility of a large loss, perhaps the value of insurance to those who do not suffer a loss can be said to be their share of the insurance company's loading charge. This would not be unreasonable even if *ex post* the risk related premium can be said to be worthless.[134] Achieving this result when a deduction for the premium is allowed would entail the additional difficulty of separating out the nondeductible loading charge. For these reasons, exclusion of proceeds and nondeductibility of premiums would seem to be a better choice than inclusion of proceeds and deductibility of premiums, assuming one or the other were theoretically correct.

There are, however, reasons why deductibility of premiums might not be generally accepted. As noted below in section D, the insurance premium would reflect the difference between the expected value of the product and the value if the event insured against does not occur. Because of the insurance protection, in all circumstances, the insured achieves the value determined as if the insured event did not occur. Thus, the total amount spent, the cost of the product plus insurance, equals the value received. Treating the insurance premium as a loss, in a sense, ignores the excess of the total value over the price of the product, just as treating insurance proceeds as income ignores the decline between price and actual enjoyment when a loss occurs.

In any event, justifying non-taxation of recoveries on the grounds that it compensates for nondeductibility of premiums would not apply to recoveries from a tortfeasor. It could not be argued that if premiums were deductible and proceeds taxable, the parties could adjust by increasing the size of the policy. Here any adjustment, such as increasing the recovery to the victim to compensate for taxes, could have real consequences. For these reasons, I do not rely on this argument to justify exclusion for recoveries.

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133. Kaplow, supra note 36, at 1493-1504 (insurance would exceed the sum of the potential loss and the lower than expected taxes). Kaplow defines "moral hazard" as the "tendency of individuals to take less effort to control costs when some or all of their costs are borne by others, such as the insurer." Kaplow, supra note 36, at 1494.

134. William Vickrey, Insurance Under the Federal Income Tax, 52 Yale L.J. 554, 557 (1943).

D. *Recovery Offset by Loss*

The difficulty of explaining exemption for recoveries could be avoided if we acknowledge that the recovery itself might produce a gain. Exemption still could be justified on the grounds that the recovery reimburses the taxpayer for a corresponding nondeductible loss. If the loss were allowed, the two transactions would be offsetting.

The loss in some cases would be the original purchase price that failed to produce value. If an automobile suffers a casualty, the recovery on the policy equals the cost of the destroyed automobile. The loss and gain balance out. The amount reimbursed in the event of bad weather on vacation would also equal the original cost which was "lost." In other situations the loss would be the additional amount expended as a result of the injury as opposed to the cost of the item which becomes unusable. For example, consider the charter traveler who purchases a round-trip ticket for $1,000 and cannot use the return flight.[135] The unused portion of the ticket cost $500, while the "value" of the recovery would be the cost of a one-way ticket, say $800. The loss would be $800, the additional "unexpected" expenditure which added no value. In the case of a fire damaged house, if there is to be a deductible loss, it would have to be the additional money spent on the hotel and food over what would have been spent had the fire not occurred.

This justification for exemption of recoveries requires an explanation as to why a deduction for losses would be denied to those who choose not to insure. The following is suggested. As noted above, if an uninsured taxpayer does not suffer any loss, the value of the actual outcome exceeds the expected value. Unless such gains are accounted for, it would be inappropriate to allow a deduction for uninsured losses.[136] Symmetrical treatment of winners and losers requires that the uninsured be denied a loss deduction even if it were appropriate to effectively allow a loss to those who are insured.

To further explain this argument, return to the previous example where we considered a $10,000 car which has a 1% chance of being a total loss. In these circumstances, the insured taxpayer pays $101 for casualty insurance, representing a $100 premium for the insurance to cover the car and a $1 premium for insurance to cover an insurance policy on the replacement car. If there is an accident resulting in a total loss he collects $10,101 which would enable him to replace the car and purchase a new insurance policy. The $10,000 gain on the insurance recovery offsets the $10,000 casualty loss. If no accident occurs there is, perhaps, neither a gain nor a loss as the owner paid $10,101 to guarantee that she will enjoy the full $10,101 value of the car

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135. See supra note 128.

136. See supra notes 76-79 and accompanying text.

as opposed to paying $10,000 for a 99% chance she will do so. Put another way, the $101 gain over the expected value of the car is offset by the $101 cost of the policy.

The uninsured driver who suffers a casualty has a $10,000 loss with no offsetting recovery on the policy. The treatment of insureds (exemption of recoveries) suggests that we should allow a deduction for this uninsured loss. But allowing this loss could systematically undervalue consumption of the uninsureds as a group. Recall that the ninety-nine uninsured taxpayers who do not have an accident obtain $10,101 worth of value for $10,000. For every uninsured $10,000 loss, there are ninety-nine $101 gains. If neither gains nor losses were taken into account, uninsureds as a whole would report the correct taxable income. Further, to the extent people who systematically do not insure could be expected to have equal amounts of gains and losses, they too would report the correct amount of taxable income.

Moreover, if the benefit to the lucky uninsureds were to go untaxed while losses were deductible, the tax system would systematically favor self-insurance. A taxpayer who is risk neutral would be indifferent between a 1% chance of a nondeductible $100 loss and a certain outlay of $1 for insurance. On the other hand, if the loss were deductible and insurance premiums were not,[137] the potential loss would be reduced while the cost of insurance would remain one dollar. This could cause even the risk averse person, who would normally purchase insurance, to self-insure. Therefore, it may be logical, on the grounds of both equity and efficiency, to deny a deduction to the uninsured even if we effectively allow a loss for an insured individual by non-taxation of recoveries.

While this approach would not explain loss disallowance to an individual who had no opportunity to insure, it should be recognized that insurance-like protection against a difference between expectancy and outcome could be achieved in a variety of forms.[138] Individuals can obtain a product warranty, lease from an owner who bears responsibility for losses or repairs, purchase a less destructible model[139] or, in the extreme, forego risky activities altogether. Consider, for example, what would have happened to the Clarks if they negligently prepared their own return.[140] When they hired an accountant, part of the fee was for the assurance of accuracy or malpractice liability for error. If they had prepared their own return they might have made an error that was not reimbursable. If they did achieve the

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137. Section 106 of Code exempts premiums on medical insurance paid by an employer, effectively allowing a deduction for premiums.

138. Kaplow, supra note 36, at 1489-92.

139. With an abundance of consumer information available, it is well known that automobiles manufactured by certain car manufacturers have better records of durability and performance.

140. See supra note 125 and accompanying text.

best result, however, they would in some sense have a gain—payment of less taxes than the average self-preparer. If this gain is not taxed, perhaps an unreimbursed loss should not be deductible.

In summary, it is possible to explain why those who forego an opportunity to insure should be denied the loss deduction which is effectively allowed by exempting recoveries. Since insurance in some form is generally available, general disallowance of unreimbursed losses may be justified.

E. *Summary and Conclusion*

A number of explanations have been offered to reconcile non-taxation of recoveries by way of insurance or otherwise with nondeductibility of losses suffered by the uninsured. These include the application of basis, the existence of an offsetting loss and the argument that there is in fact no "recovery" for the consumer.

Consistent with my belief that the value of consumption should generally be measured by the costs incurred in a market transaction, I am comfortable with the view that the "recovery" can generally be "ignored" by a taxpayer who is insured, protected by seller warranty, or reimbursed by a tortfeasor.[141] She has originally purchased a different more reliable product and her consumption is measured by the amount paid for that product, which amount includes the cost of insurance. The cost and hence the "value" of potential liability to victims, for example, is determined by the insurance premium rather than the uncertainties of future events.

This approach fits most easily with situations in which the recovery is not directly received by the taxpayer or at least must be used in connection with the original activity. In such cases it can be said that, while there may be a market transaction, the taxpayer does not have a new consumption choice. Thus, a dealer warranty can be used only to fix the car. Payments pursuant to liability insurance go directly to the victim. Blue Cross will only reimburse actual costs. The traveler stranded by his charter flight ostensibly has more choice if recovery is in cash, but nevertheless must return home.

This analysis will not cover all cases, however. The victim of a collision need not replace his auto. Vacation insurance payable in cash could be used for other purposes. Cash cannot restore violated privacy. Basis recovery may explain exemption in some circumstances, but, perhaps because the recovery would exceed the price or premium paid for protection, basis would sometimes be insufficient.

Some would argue that, regardless of basis, an individual who is no better off as a result of the transaction should not be subject to tax. While this

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141. If reimbursed by an employer, the value of that protection should be taxable. Contra Andrews, supra note 18, at 334 (suggesting employer reimbursement be tax-free).

seems too broad, a less drastic version—the idea that all involuntary receipts that leave the taxpayer no better off should be tax-free—has appeal.

In assessing this view, it is useful to consider how an individual could be said not to be "better off" if her basis is less than the amount recovered. For example, consider an individual who purchased a residence for $100,000. The property increases in value to $150,000 before being destroyed by fire. While insurance proceeds of $150,000 would leave the taxpayer no better off, it is clear that, in the absence of reinvestment, the amount received in excess of basis, $50,000, would be taxable.[142] The fire becomes the occasion to recognize the previously unrealized gain. "No better off" in this context must mean, therefore, that even though basis is inadequate, there is no "unrealized gain." How could that occur?

Two possibilities may be suggested. First, the recovery reimburses the taxpayer against an expense, subsequent to the original purchase, which provides no additional utility. Examples include a tort judgment from negligent operation of an automobile, a return flight from Europe when the traveler cannot for some reason use the previously booked charter and, perhaps, the cost of a hotel room when fire makes the taxpayer's residence unusable. Second, in the absence of injury, the individual had access to a form of tax-free consumption; for example, privacy, use of one's body, or imputed income from use of a residence or one's own services.

The first possibility seems easier to deal with. In most of these cases, as noted above, the recovery does not enable the consumer to vary the form of purchase and thus can reasonably be considered irrelevant. Even if this is not the case, it seems unfair for a person who is no better off than he would have been had he not been injured or suffered a loss to bear a larger tax burden. Thus upon comparison to the uninjured, exemption seems required so as not to tax the injured more heavily. One way to justify exemption is by assuming that for any income there is an offsetting loss. Thus, any taxable income from the reimbursement of the cost of a vacation, ruined by bad weather, would be offset by a "loss" for the difference between the original cost of the vacation and the actual benefit derived. This might suggest, however, that the injured party who does not recover should have a deductible loss.[143] Nevertheless, while it might be more appealing to allow a deduction to the unreimbursed individual in order to treat all three situations consistently, we have seen that there are reasons for denying a loss for those who choose not to insure. Since insurance in some form is available with respect to most purchases, the denial of deductions for unreimbursed losses does not necessarily determine how "insured" losses should be treated. If this is so, exemption for recoveries can more comfortably be justified by the

142. IRC § 1001(a).

143. Cf. Zelenak, supra note 114, at 388.

assumption that there is a corresponding loss which should be allowed to those who are insured.

There would be cases, however, where a loss could not be found. For example, to the extent recovery for physical injury, such as loss of a limb, exceeds additional out-of-pocket costs, there would be no additional expenditure for the injured person to deduct as a loss.

This analysis suggests that the most difficult cases involve the substitution of money for tax-free benefits such as the use of one's body or the imputed income from home ownership. It is at least difficult, if not impossible to say that there is no change in the original form of consumption;[144] there is clearly no basis to recover and in the case of one's body no offsetting loss. The home ownership issue was considered in *Millsap v. Commissioner*[145] and *McCabe v. Commissioner.*[146]

Millsap owned his own home and appliances and enjoyed tax-free imputed income[147] from their use and from his own services in cooking, cleaning and doing laundry. The home became temporarily unusable because of fire, and as a consequence Millsap's access to such imputed income was interrupted. Millsap, however, was covered by insurance that reimbursed the cost of temporary living quarters, as well as the additional expenses of laundry and food.

It would appear that the additional costs incurred by Millsap after the fire would in effect reflect the loss of the imputed return from his residence and its contents, the absence of his input in cooking and cleaning, which made food and laundry more expensive, and the depreciation on his residence for the period of absence.[148]

Despite the fact that Millsap seemed no better off, the Internal Revenue Service concluded that the recovery was taxable to him.[149] It

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144. Use of proceeds to rent living quarters could be considered similar enough to home ownership so that there is no change in the original form of consumption. However, money in lieu of privacy is clearly different.

145. 387 F.2d 420 (8th Cir. 1968).

146. 54 T.C. 1745 (1970).

147. Michael J. Graetz, Federal Income Taxation Principles and Policies, 152-54 (2d ed. 1988).

148. The assumption is that the hotel must charge enough to cover its operating costs for utilities, laundry and meals, depreciation of its assets and a return on its investment. Millsap's operating costs in the absence of the fire would be similar except for the value of services. Thus, his excess costs cover imputed income from property and services and depreciation. If Millsap's residence continues to depreciate despite being unoccupied, he must bear this cost plus his share of the hotel's depreciation expense, which indicates why this cost should be reimbursed even though the amount he normally spends on utilities, for example, need not be.

149. Millsap v. Commissioner, 46 T.C. 751 (1966), aff'd, 387 F.2d 420 (8th Cir. 1968). Accord McCabe v. Commissioner, 54 T.C. 1745 (1970); Arnold v. U.S., 289 F. Supp.

asserted that while the taxpayer could enjoy tax-free imputed income from the use of his residence and his own services, the entire cost of rent, food and laundry must be purchased with after-tax income. Moreover, if Millsap rented the residence, cash received would be taxable even if used to rent another home. Therefore, cash received from an insurance company was taxable because, in a sense, it could be said to be effectively renting the property.[150]

In sum, what Millsap was seeking was continued tax-free treatment for an amount equal to the imputed value of the goods and services he enjoyed prior to the fire, even though the fire deprived him of his access to this in-kind income and the insurance company replaced it with cash. The Internal Revenue Service, on the other hand, viewed the tax-free benefits as lost. In *McCabe* the court recognized the dilemma, but opted for inclusion of insurance proceeds in the absence of basis. It specifically rejected an exclusion put forth on the grounds that the proceeds were in fact a substitute for a nontaxable type income.[151] I think the Tax Court got the question exactly right in *McCabe*, namely, Whether one should be taxable when he has been forced against his will to shift the form of consumption from a nontaxable form to a taxable one?

This issue also arose in a private letter ruling[152] in which the Internal Revenue Service dealt with a tenant in a rent controlled building who received $20,000 in exchange for giving up his apartment and all claims against the owner for fraud and for scheming to end rent control by violating rules against seeking non-tenant buyers. The Service held the $20,000 to be taxable.

If the taxpayer were otherwise able to retain his rights to the apartment, at least temporarily, the $20,000 compensates him for higher rents he will have to pay elsewhere for similar quarters; he is not better off than he would have been if he stayed in his apartment.[153] The $20,000 payment merely reimburses the extra cost of the more expensive apartment which provides no additional utility. The tenant has, however, exchanged access to an apartment at a below market rent, a form of nontaxable benefit, for cash

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206 (E.D. N.Y. 1968). But see Conner v. U.S., 303 F. Supp. 1187 (S.D. Tex. 1969), aff'd in part and rev'd in part, 439 F.2d 974 (5th Cir. 1971); Taylor v. U.S., 28 AFTR 2d 6108 (N.D. Ala. 1971).

150. If this analogy is appropriate, Millsap should be entitled to a depreciation deduction, which would mean that his taxable income would equal the lost imputed income from property and services.

151. *McCabe*, 54 T.C. at 1748.

152. Priv. Let. Rul. 8952030 (September 29, 1989).

153. Alternatively, the $20,000 might reflect a discount from market being provided to existing tenants who buy these apartments. Under this view, the $20,000 is akin to the profit he might have obtained by purchasing the apartment and reselling it as soon as he was free to do so. This would seem to be taxable.

which would ordinarily be taxable. If the transaction is voluntary, it would seem clearly taxable, but the answer is more difficult if the tenant was in someway coerced, perhaps by the landlord's fraudulent behavior. It is appealing to permit the substitution to be tax-free when it occurs without the individual exercising any choice.[154]

Cash substituted for a limb or for the pleasure of being pain-free seems to me to be properly nontaxable.[155] The *Millsap* case seems harder because while we all enjoy tax-free use of our bodies, renters and homeowners are treated very differently by the tax law.[156] Should Millsap retain the more favorable homeowner treatment just because his shift to rental status was against his will?[157]

Proper measurement of income would require that imputed income from home ownership be included in the base. The exclusion must be defended on administrative grounds or more likely because the public would not accept the inclusion. Therefore, there is no theoretical way to determine how far to extend exemption for imputed income. If public perception is the key, I would guess insurance recoveries in the *Millsap* circumstances and similar situations, such as to temporarily replace a stolen car, would be exempt as indicated by the prompt enactment of section 123 to overrule *Millsap*.

I find this result acceptable while at the same time I applaud the Service's conclusion regarding the tenant who lost his rent controlled apartment. The distinction may be that the tenant had a special advantage, access to a rent controlled apartment. While we generally do not tax the value

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154. This is similar to Kelman's view that the involuntary nature of the transaction is controlling although I found Kelman's reasoning unpersuasive. See supra text accompanying note 123.

155. Contra Griffith, supra note 24 at 374; Joseph M. Dodge, Taxes and Torts, 77 Cornell L. Rev. 143, 182 (1992). The utilitarian approach would justify exclusion of personal injury recoveries only if the impact of personal injury increased the injured recipient's need for income. "If the victim ... has no greater economic need as a result of the injury ... payments should be subject to taxation." Griffith, supra note 24, at 374.

See also William A. Klein, Tax Effects of Nonpayment of Child Support, 45 Tax Law Rev. 259, 271 (1990).

156. Imputed income from home ownership is not taxed while rent is not deductible. Regs. § 1.262-1(b)(3). In one sense at least, tax exemption is more easily explainable in *Millsap* on the grounds that the loss incurred from the expenditure on his hotel room (which provided no additional utility) could offset the proceeds. Loss of privacy does not necessarily increase one's costs.

157. In an analogous situation, Simons justifies present IRC § 119, which excludes the value of lodging from income when an employee is required to reside on the business premises for the "convenience of the employer," as providing benefits similar to home ownership to those who, because of the nature of their work, are not free to buy their own home. Simons, supra note 1, at 123-24.

generated by below-market purchases, there seems to be no reason to continue favorable tax treatment when the special status is lost. Millsap, on the other hand, is a member of a much larger group—homeowners. He merely seeks to continue to be treated like all the rest. Still, if Millsap loses, he is merely treated like all renters. Thus, I am less comfortable with tax-exemption for Millsap than I am with tax exemption for payments for physical injury or loss of privacy.[158] Ultimately, the conclusion may reflect intuition rather than logic.

It was also suggested above that tax-free treatment for insurance recoveries could be defended on the grounds that premiums should be deductible if recovery is taxable. The validity of this argument, which was previously questioned, will be developed more fully in the next section.

V. Insurance Against Loss of Income

As a final matter, I want to briefly consider whether the discussion thus far leads to any *preliminary* conclusions concerning taxation of insurance that provides protection against loss of income as opposed to protection of an item of consumption. In the case of an item of consumption, I have argued that generally proceeds from such insurance should not be included in income and the premium should be nondeductible. Does this conclusion apply to insurance against loss of income as well?

Under current law this treatment—nondeductibility of premiums and excludibility of recoveries—is accorded premiums on and proceeds of insurance to protect against loss of income from "personal" risks of illness or death.[159] On the other hand, premiums on insurance to protect against "business" risks are deductible[160] and in that situation the proceeds are included in income. Thus, a storekeeper who buys business interruption insurance is taxable on the proceeds, but the premium is deductible. The Internal Revenue Service would also allow a deductible business expense to an employee who sought protection against loss of income caused by a business risk—from on the job injury or unemployment caused by an industry decline.[161] But according to the Service, the cost of protection against a loss of income from personal causes such as illness or death caused by a non-job related injury or disease would not be deductible.[162]

158. Replacement of lost earnings, of course, should be taxable.

159. IRC §§ 101, 104(a)(3), 262; Regs. § 1.262-1(b)(1). The value of a limited amount of group-term life insurance provided by an employer is excluded from income under IRC § 79, which is equivalent to a deduction for the premium and an exclusion of proceeds.

160. IRC § 162.

161. G.C.M. 39016 (January 18, 1983). See Rev. Rul. 81-193, 1981-2 C.B. 52.

162. Rev. Rul. 81-193, supra note 161.

This distinction has little practical importance, since where a deduction is not allowed, the proceeds have been excludible and, as we have seen, the two approaches can produce equivalent results. As described above,[163] as long as brackets are the same, the insured can adjust to the taxability of the benefit by the purchase of additional insurance. If the premium is deductible, the net cost does not increase. Disallowance of a deduction for premium payments and treating the proceeds as exempt is merely a simpler way to achieve the same result as a deduction for the premium and taxation of recoveries.

In fact, tax-free treatment of mortality gains on life insurance cannot be justified on the grounds that the taxpayer is no better off than she would be if the insured lived (if the insured lived, earnings would be taxable), or that the gain on insurance would be offset by a deduction for lost earnings (failure to earn cannot lead to a deduction). The only viable explanation for the tax-free treatment of mortality gains is that the exemption is balanced by a denial of a deduction for the premium, which would be allowed as a cost incurred for the production of income if life insurance proceeds were taxable.[164] Some, however, who argue that life insurance proceeds should be taxable, view the premiums, not as a deductible cost of producing what should be taxable income, but rather as a nondeductible personal expense to achieve comfort and peace of mind.[165]

This discussion suggests two questions for consideration. First, is it possible that the purchase of insurance, which increases utility by reducing risk, should be viewed as enlarging the tax base? Second, if the purchase of insurance does not create any additional overall income,[166] is it more appropriate to tax the proceeds and deduct the premium or to exempt the proceeds and treat the premium as nondeductible?

Turning to the second question, there is, I believe, a distinction between life and disability insurance on the one hand and, for example, collision coverage on the other. As we have seen the purchase of casualty insurance increases the value expected from the automobile—it means full value will be obtained in all circumstances, not just in the absence of a casualty.[167] It seems clear, therefore, that a deduction for the insurance premium would not correctly measure the enjoyment of an individual whose car is undamaged. If the premium is to be deducted, there must be an offsetting amount of income, the difference between the value produced by the

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163. See supra text accompanying note 131.

164. Robert B. Harris, Comment, Compensation for Loss of Income and Its Taxation, 34 Nat'l Tax J. 135 (1981).

165. William D. Popkin, Taxing Personal Insurance: The Case of Tax Audit Insurance, 4 Va. Tax Rev. 379, 403 (1985).

166. Warren, supra note 23, at 1087.

167. See supra note 129 and accompanying text.

car (outcome) and the purchase price (expected value).

Life insurance presents a different picture. Since in this case the excess of actual over expected income is subject to tax, there may be said to be a double counting of income if the premium is not deducted. Assume a taxpayer, who has a 99% chance of surviving through next year, will earn $10,101 if she does. Thus, assuming she is risk neutral, the expected value of her future income is $10,000. If $10,101 of life insurance is purchased at a cost of $101, there is now a 100% chance of receiving this expected value—salary or life insurance proceeds of $10,101 less premium of $101. However, if she lives what will be taxed is the actual amount she earns, $10,101, not the expected value. Therefore, unless the premium is deductible, the purchase of life insurance would increase her expected income. Furthermore, if the insured dies, there is no loss to offset the proceeds. The insurance provides additional value. Therefore, in the case of life insurance, deduction of the premium and taxation of proceeds is at least in theory more appropriate than the opposite approach which was suggested for casualty insurance.

As noted, however, a deduction for the premium means everyone will be taxed at the expected value. Is this the proper income for an insured who lives? Is true income just $10,000 since she must pay $101 to assure she will receive the expected income in all circumstances or does such a person actually earn $10,101?

We can examine the question by comparing two people who survive. A is uninsured and has $10,101 to spend on food and drink. B is insured and, after paying the premium, has only $10,000 to so spend. Should A pay more tax than B, or does B have $101 worth of peace of mind or security?

It might appear that B has as much consumption as A. He merely chooses to spend some of his resources on insurance which makes him feel more secure. It therefore seems hard to argue that B, if he lives, has less than A, if he lives. They both have $10,101. If B were to die, however, it seems that the insurance should be valued at $10,101 not its *ex ante* value of $101. After all, unlike A's family when A dies uninsured, B's heirs can consume at least $10,000 worth of goods and services when B dies insured.

If these suggestions are followed the purchase of insurance would increase overall income.[168] If there is no insurance, there would be a total

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168. Gambling raises a similar issue. Suppose C gambles $1 on a 100 to 1 shot (assume no take for the house or the state). In the absence of the bet C has a 100% chance of $1 equaling $1. With the bet C has a 1% chance of 100, which also equals 1.

Life insurance would be seeking to protect against risk—to change a 99% chance of $100, into a certainty of $99. When one gambles he is moving from certainty to a risky situation. In both cases, however, the expected value of resources does not change.

If gambling winnings are taxable while losses are not deductible, taxes nevertheless increase. The justification for this result may be the loser, despite his loss, has $1 worth of

of $1,000,000 for each one hundred people, $10,101 for each of the ninety-nine who live and zero for the one who dies. But if everyone is insured, total income would be $1,010,100 ($10,101 not $10,000 for each).

Insurance, by reducing risk, does increase overall utility but if this argument for nondeductibility of the premium and taxation of proceeds is valid why would it not extend to business interruption insurance as well. In the case of insurance against business risk, by allowing a deduction for premiums we do not include the value of peace of mind in the tax base.

Perhaps one way to resolve this apparent dilemma is to recognize that A and B are not identical. A is risk neutral. He views a 99% chance at $10,101, and a 1% chance that he will earn nothing, as equivalent to a 100% guarantee of $10,000. Therefore, he need not insure.

B being risk averse considers the former option less valuable than the latter. To B the expected "value" of the former option is less than $10,000. Therefore, when B guarantees that he will receive $10,000, the expected "value" of his income increases, which would not be inconsistent with a higher tax burden. However, what B has achieved through insurance (an expected value of $10,000) is merely what A already has because of his greater tolerance for risk. Therefore it is not necessarily clear that B should pay a greater "expected" tax than A. This would occur if all Bs were taxable at $10,101,[169] while As would only be so taxed if they lived. Perhaps we need not worry about discrimination between A and B, if most people are in fact Bs. But if that were the case, it might not matter what tax base were chosen for B.

Apart from equity considerations, taxation of insurance proceeds without a deduction for premiums could be said to create a disincentive to insure. A risk neutral individual would certainly not want to increase her expected tax burden without an increase in the expected value of income. However, in the case of B, the additional security from alleviating the risk could offset the additional tax burden.

For example, assume the tax rate is 20%. If B insures, his pre-tax cash income after insurance is $10,000 and his tax liability is $2,020.20 based on $10,101 of income. In all circumstances B or his heirs will have $7,979.80 in cash after tax. If B did not insure, he would have $8,080.80 if he lives (80% of $10,101). The expected value, given the 99% chance of survival, is $8,000, which is greater than the amount available to the insured if the premium is not deductible. However, if B is risk averse, he might not

consumption from the excitement of gambling. A consumption value to gambling seems plausible whether or not the same can be said for life insurance.

169. Equivalent treatment in the case of casualty insurance would require not only that premiums not be deducted, but that, in addition, an amount equal to the premium be included in income.

consider a 99% chance for $8,080.80 more valuable than $7,979.80. After taking account of risk, he might prefer a lower expectancy. Thus, he might still insure.

In the end, I believe I would continue to allow insurance proceeds to be tax free as long as the premium is not deductible.[170] Since the government would not be placing a charge on diminution of risk, this approach would be certain not to hinder a decision to insure. It would also avoid difficult questions about deductibility of what has clearly always seemed to be business expenses—such as expenditures for business interruption insurance.[171]

VI. SUMMARY

This paper has shown that measuring consumption by outlay is generally supportable even if one believes that ideally outcomes should be taken into account, and that non-taxation of recoveries which exceed basis can be reconciled in most cases with nondeductibility of losses for the uninsured.

If consumption is measured by outlays, insurance is generally just another outlay, albeit for a different and more expensive product, and any recovery under the policy can in most cases be thought of as merely a means of preventing an increase in the costs of an activity, which activity has not changed. Cash which is freely available for other purposes, particularly if it replaces normally tax free benefits presents more difficulty.

If outcomes matter then non-taxation of recoveries can be justified by asserting that there should be a deduction either for the premium or for the loss that has been incurred. The latter rationale does not necessarily support

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170. It was noted above that exclusion of proceeds combined with non-deductible premiums is not the same as taxability and deduction if the insurance company increases its premium to cover expenses and profit. See supra note 133 and accompanying text. For example, assume in the above case that the premium is $102. If the proceeds are excluded those who live are taxed on $10,101 whether they are insured or not. Those who die would not be taxed in either event. Insurance does not change the expected tax liability. However, if the proceeds are taxable and the premium of $102 is deductible, the tax base for those who insure, both expected and actual would be reduced to $9,999. It seems better to assume that income does not in fact decline when insurance is purchased. This would be achieved if the loading charge were non-deductible, or more directly by excluding the proceeds and treating the entire premium as non-deductible.

171. In fact, if business insurance is held to be non-deductible, would similar reasoning cast doubt on the deduction for other items like security guards? Suppose a business determines that in the absence of a robbery, it will earn $100,000 per year. There is, however, a 50% chance of a theft, which will reduce its income to $90,000. Suppose hiring a security guard for $5,000 will prevent the robbery, so that actual and expected income will be $95,000. Could it nevertheless be claimed that taxable income is $100,000?

deductions for the uninsured. Denial of such deductions follows from the failure, which has not generally been recognized, to tax gains when actual costs are less than expected. Since gains and losses can be thought to ordinarily balance out, it is best to take neither into account.

Deduction of premiums on insurance to protect against loss on consumer purchases would, however, not correctly measure income. It can only be justified as a balance to another "error"—taxation of proceeds without recognition of the offsetting loss. The issue of whether premiums on policies which protect against loss of income should be deductible may be more difficult. This article offers only a tentative position in favor of such deductibility, assuming proceeds were to be taxed.

Thus, the tax system, properly, does not take account of Andy's unfortunate experience with his Mercedes. On the other hand, if he could recover from the dealer, the amount received should be tax-exempt.